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Ukraine
Macroeconomic Situation

THE BLEYZER FOUNDATION
Turning Transitions Into Prosperity

February 2013

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- **Real GDP grew by 0.2% yoy in 2012 amid a more challenging external environment and cooling investment demand.**
- **The decline in industrial production eased to 3.2% yoy in January 2013, while agriculture and retail sales continued to expand at a robust pace.**
- **The state budget deficit widened to 3.8% of GDP in 2012 due to revenues falling short of the target and a loose expenditure stance.**
- **The pension fund deficit was higher than originally expected in 2012 and is set to increase further in 2013, undermining government efforts to sustain its social security system.**
- **Consumer prices fell by 0.2% yoy in January 2013 due to continuing food price deflation and a moderate increase in utility tariffs. Inflation, however, is forecast to accelerate to about 8% yoy at the end of the year.**
- **The foreign exchange market remained relatively calm during the first months of 2013, but Hryvnia depreciation risks remain elevated.**
- **Despite the improved deposit base and liquidity stance of the banking system, bank lending remained anemic at the beginning of 2013.**
- **The current account gap widened to $14.4 billion or 8.2% of GDP in 2012, but is projected to narrow to around 7% of GDP in 2013.**
- **The IMF mission came at the end of January-beginning of February 2013 to hold the first round of negotiations on a new bailout loan to Ukraine.**

Executive Summary

Due to continuing weakness in foreign demand and sluggish investment activity, Ukraine's GDP contracted by a real 2.7% yoy in 4Q 2012. However, thanks to relatively robust growth in 1H 2012, the country avoided a decline in GDP for the year 2012 with GDP expanding by a real 0.2% yoy. Although economic growth is forecast to remain lackluster in 1H 2013, January's real sector data revealed tentative signs of improvement.

The decline in industrial production has lost momentum, as output fell by 3.2% yoy in January 2013, underpinned by further gains in domestic food processing and light industry, and improvements in metallurgy and machine-building. Agriculture and retail sales continued to be the bright spots of the Ukrainian economy. Agricultural output advanced by 5.6% yoy in January 2013, underpinned by solid expansion in animal breeding. Thanks to vigorous wage growth (up by a real 10.2% yoy), retail sales turnover grew by 14.2% yoy for the period. On the downside, weaknesses in the industrial sector and moderation of agricultural exports weighed on wholesale trade and cargo transportation. Looking ahead, we believe that private consumption will remain the main driver of economic growth in 2013. Its impact, however, is forecast to weaken through the course of the year amid anticipated fiscal tightening and acceleration in inflation. But coupled with government policy to reduce energy imports, it will also dampen the growth of imports. Gradual resumption of global trade will support exports, compensating for subdued investment demand. All in all, real GDP is forecast to advance by about 2% yoy in 2013.

The economic downturn in 2H 2012 and loose fiscal policy ahead of parliamentary elections led to sharp deterioration in public finances in 2012. The state budget deficit widened to 3.8% of GDP, while the general public sector deficit (including Naftogaz and Pension Fund deficits) is estimated to have approached 6% of GDP. The state budget deficit is targeted at 3.4% of GDP in 2013. However, due to government reluctance to raise natural gas tariffs to the population and a planned increase in the Pension Fund deficit, the fiscal deficit in 2013 may amount to around 5% of GDP. The size of the planned fiscal gap for 2013 is unlikely to satisfy the IMF. Assuming Ukraine eventually reaches a new agreement with the IMF, we forecast the fiscal deficit will be reduced to about 4% of GDP in 2013.

Ukraine continued to enjoy low consumer price growth in the first month of 2013. The annual price index remained 0.2% yoy lower in January 2013, mainly thanks to continuing food price deflation (down by 2.2% yoy) and a modest increase in utility tariffs. Anticipated adjustment in utility tariffs amid a low base effect is forecast to drive annual price growth to about 8% yoy at the end of 2013.

The foreign exchange market was relatively calm at the beginning of 2013. Administrative restrictions on foreign currency trade introduced in November last year reduced population demand for foreign exchange and helped to increase supply of foreign currency to the market. Improved public and private debt inflows (additional issuance of sovereign Eurobonds at the beginning of February 2013 and Eurobonds placement by state-run Ukreximbank in January 2013) as well as the issuance of government securities in foreign currency also helped to ease Hryvnia depreciation pressures. Despite a favorable near-term outlook, the risk of Hryvnia depreciation remains elevated due to a large current account gap and high external debt financing needs.

The current account gap widened to $14.4 billion or 8.2% of GDP in 2012, a new high for Ukraine. A weak external trade environment weighed on Ukrainian exports, while imports rose at a faster pace, underpinned by robust domestic consumption. Somewhat slower domestic

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consumption growth and government policy to reduce energy imports will contain large increases in the current account deficit in 2013. The current account deficit is projected to narrow to around 7% of GDP. Despite this improvement, Ukraine's external imbalances will remain large in 2013 as the country is facing significant external debt repayment requirements. In addition, the NBU's gross international reserves have declined to below three months of imports at the end of 2012. Although Ukraine successfully accessed the Eurobonds market in 2012 and at the beginning of 2013 and financing conditions on international markets have been gradually improving, it is unlikely to cope with its funding needs without IMF financing.

The mission came to Ukraine at the end of January-beginning of February 2013 to evaluate the current economic situation and discuss structural adjustment policies. Additional placement of $1 billion Eurobonds at the beginning of February 2013 gave the Ukrainian authorities some time to negotiate a new IMF loan, which is now expected to be approved in summer 2013. Raising natural gas tariffs to the population, fiscal consolidation and a more flexible exchange rate regime are likely to remain among key IMF requirements. With the IMF deal, Ukraine will be able to cover its financing needs but due to the latter condition, the Hryvnia may moderately depreciate. Without the IMF agreement, Ukraine may experience sharp depreciation unless it secures sufficient financing on international borrowing markets (assuming their notable improvement in 2013) or reaches bilateral agreement with Russia.

	2009	2010	2011	2012[e]	2013[f]	2014[f]
GDP growth, % yoy	-14.8	4.1	5.2	0.2	2.0	4.0
GDP per capita, $	2 545	2 974	3 575	3 864	4 060	4 365
Industrial production, % yoy	-21.9	11.2	7.6	-1.8	1.5	3.0
Retail sales, % yoy	-16.6	9.8	14.8	15.9	-	-
Budget deficit, % GDP*	-8.9	-7.0	-4.3	-5.6	-4.0	-2.5
Government external debt, % GDP	20.5	23.8	20.4	18.5	19.0	19.1
Inflation, eop	12.3	9.1	4.6	-0.2	6.0	5.0
Gross international reserves, $ billion	26.5	34.5	31.8	24.5	25.0	27.0
Current account balance, % GDP	-1.5	-1.9	-5.5	-8.2	-7.1	-6.6
Gross external debt, % GDP	88.2	86.0	77.2	75.7	74.8	72.0

*Including Naftogaz and Pension fund deficits (not including bank recapitalization expenditures and VAT refund bonds in 2009 and 2010 respectively).
Source: State Statistics Committee of Ukraine, NBU, Ministry of Finance of Ukraine, 2013 Budget Law, The Bleyzer Foundation

Economic Growth

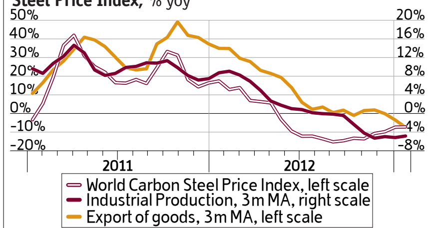
Ukraine started 2013 with tentative signs of improvement, although overall the economy remained in the doldrums. According to preliminary data of the State Statistics Committee of Ukraine, real GDP contracted by 2.7% yoy in 4Q 2012 following a 1.3% yoy drop in the previous quarter. Economic contraction for two quarters in a row signaled that the economy has fallen into recession, the second in four years. On a positive note, thanks to relatively robust growth in 1H 2012, the country avoided a decline in GDP for the 2012 with GDP expanding by a real 0.2% yoy. While economic weaknesses, stemming from subdued foreign demand and sluggish investment activity, were expected to persist at the beginning of 2013, real sector data for January 2013 revealed some uplift in economic activity.

Real Sector Performance of Ukraine
% yoy

	Jan 13	2012	2011	2010
Agriculture	5.6	-4.5	17.5	-1.5
Industrial output	-3.2	-1.8	7.6	11.2
Construction works	-15.2	-13.8	11.1	-5.4
Domestic trade turnover				
Wholesale trade	-7.3	-4.4	0.6	0.4
Retail trade	14.2	15.9	14.7	9.8
Restaurants	6.1	8.2	11.0	3.5
Transportation turnover				
Cargo	-13.0	-7.6	5.7	6.4
Passenger	-4.4	-1.2	3.3	-0.2
Services, non-financial	2.9	8.7	18.6	2.9

Source: State Statistics Committee

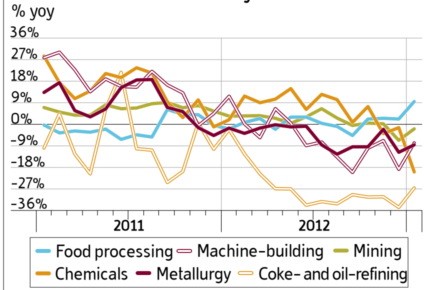
Ukrainian Industry and Exports of Goods, and World Steel Price Index, % yoy



Source: MEPS, NBU, The Bleyzer Foundation

The decline in industrial production lost momentum as output fell by 3.2% yoy in January 2013, compared to a 7.8% yoy decline in December 2012. The improvement reflected further gains in domestic food processing and light industry and a more modest output decline in export-led metallurgy. Thus, thanks to favorable developments in agriculture and strong domestic consumption, food processing output edged up an impressive 9.5% yoy in January. The first month of 2013 brought additional evidence that world steel prices bottomed out at the end of last year. According to MEPS, the global carbon steel price index grew by about 3% from November 2012 to January 2013, suggesting world demand for steel products has been gradually recovering. As a result, a slump in Ukraine's export-reliant metallurgy slowed to 8.6% yoy in January 2013 from almost 12% yoy a month before. In addition, although the local machine-building industry (particularly production of motor vehicles) continued to suffer from less friendly relations with Russia, the slump in industry lost steam as output fell by 7.8% yoy in January 2013 compared to almost 19% yoy in December. Such improvement may be explained by producers' inventory being rebuilt as well as strong domestic demand for electronic appliances[1]. On the downside, chemicals and domestic oil-refining kept demonstrating weak activity. Being sensitive to energy prices and facing severe import competition, these industries reported a 20% yoy and 27% yoy decline in output production. The pace of industrial activity is likely to remain lackluster during the coming months due to subdued foreign demand and forecast softening of domestic consumption. The sector's performance, however, is forecast to strengthen gradually in line with improvements in the external environment.

Industrial Production Growth by Select Branches



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Agriculture and retail sales continued to be the bright spots of the Ukrainian economy at the beginning of 2013. Good crop harvests for two years in a row underpinned solid development in animal breeding. As a result, agricultural output expanded by 5.6% yoy in January 2013. Thanks to vigorous wage growth (up by a real 10.2% yoy), retail sales turnover grew by 14.2% yoy for the period. A solid increase in retail sales implied the continuing positive impact of private consumption growth on the economy. This impact, however, is forecast to weaken through the course of the year amid anticipated fiscal tightening and acceleration in inflation.

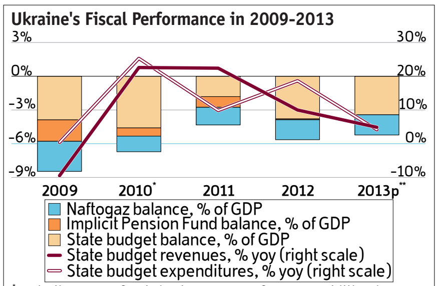
In the meantime, weakness in the industrial sector and moderation of agricultural exports weighed on wholesale trade and cargo transportation. Over the period, turnover in these sectors went down by a real 7.3% yoy and 13% yoy, respectively. In addition, weak credit activity and retrenchment of budget spending on public construction projects caused further contraction of construction production. The volume of construction works fell by 15.2% yoy in January, down from 14% yoy reported for 2012. A strong base effect (due to completion of large infrastructure projects related to the Euro 2012 soccer tournament) and continuing financing constraints (due to weak bank lending activity) suggest weak sector performance in 1H 2013. As the provision of credit is expected to improve in 2H 2013 and the influence of a high statistical effect will dissipate starting in May, a gradual recovery in the sector may be expected.

To sum up, economic activity remains subdued at the beginning of 2013. This, however, was in line with expectations, as a weak external environment and tight domestic credit continued to be a drag on growth of the export-dependent Ukrainian economy. Looking ahead, the positive momentum in private consumption is forecast to continue supporting economic growth. At the same time, due to anticipated tighter fiscal policy, consumption is likely to grow less rapidly. But coupled with announced reduction in the volume of energy imports, this will also dampen the growth of imports. Gradual strengthening of the trade environment, likely more pronounced in the second half of the year, should support exports. On the downside, slow implementation of structural reforms to improve the business environment and efforts to address fiscal imbalances may weaken the recovery. All in all, the Ukrainian economy is projected to grow by about 2% yoy in 2013.

Fiscal Policy

The budget revenue shortfall due to the economic downturn in 2H 2012 and loose fiscal policy led to sharp deterioration in public finances in 2012. State budget revenues grew by a nominal 10% yoy to UAH 346 billion ($43.3 billion) in 2012, but missed the target by about 7.5%. Despite intensified revenue collection efforts of tax and customs, primary taxes delivered poor results. Proceeds from corporate income tax were only 1.1% yoy higher in nominal terms, while VAT receipts rose by 6.7% yoy. The growth in budget revenues was underpinned by import-related collections of taxes and duties; however, it would have been much lower without NBU support. The National Bank channeled UAH 23.6 billion of its profits to the budget, or almost 7% of total budget revenues. NBU profit transfer is stipulated by the law on the central bank. De facto, however, such transactions may be treated as implicit monetary financing of state budget deficits. Indeed, actual NBU profit transfers exceeded the initial target for 2012 by almost 2.5 times.

Ukraine's Fiscal Performance in 2009-2013



*Excluding VAT refunds in the amount of UAH 16.4 billion in 2010;
**According to current 2013 state budget law and assuming the lack of reform in energy sector (Naftogaz).
Source: MinFin, 2013 State Budget Law, The Bleyzer Foundation

Although state budget expenditures were under-fulfilled by 4.3%, they accelerated to a nominal 18.7% yoy in 2012, compared to less than 10% yoy in the previous year. The speed-up in budget spending may be mainly attributed to pre-election spending on social welfare and social protection, which advanced by 31% yoy. As the growth of expenditures noticeably outpaced revenues, the state budget deficit widened to UAH 53.5 billion, or 3.8% of GDP, in 2012. At the same time, the overall public sector deficit likely approached 6% of GDP if payments to cover Naftogaz imbalances and the Pension Fund deficit are included.

[1]For instance, production of computers and other electronic devices edged up 2.3 times in January 2013 compared to the corresponding period last year.

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The higher price for imported natural gas (amid government unwillingness to increase heavily subsidized natural gas tariffs for the population and heating companies) was the main reason for protracted financial difficulties in national oil and gas monopoly Naftogaz Ukrainy. Consequently, the company requires government support to cover its deficit, estimated at about 1.8% of GDP in 2012. Given worsening state budget performance in 2012, the Naftogaz deficit has become increasingly burdensome for public finances, highlighting the need to reform the existing system of energy subsidies to the population.

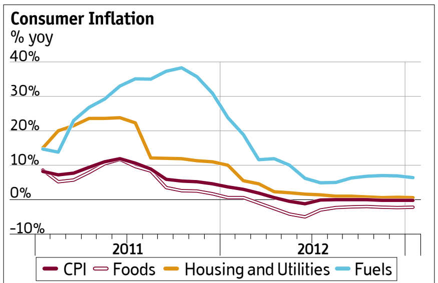
Thanks to a number of government measures enacted in mid-2011 (such as raising the pension age for women, capping maximum pension benefits for new pensioners, etc.), the Pension Fund deficit narrowed to UAH 16.4 billion, or 1.2% of GDP, in 2012, according to the Ministry of Social Policy. This was a notable improvement from the 2.3% of GDP deficit in 2011. Originally, however, the impact of the above-mentioned measures to stabilize Pension Fund finances was projected to be more profound, with the ultimate goal of eliminating the Fund's deficit. Election-induced increases in pension payments resulted in a wider than initially expected deficit. According to the Pension Fund budget, both the deficit and expenditures are set to increase in 2013. More comprehensive pension reform is required to make the pension system and public sector finances sustainable.

According to 2013 state budget law, the deficit is targeted at 3.4% of GDP. Since virtually no actions were announced to reduce Naftogaz and Pension Fund deficits, the fiscal deficit in 2013 may remain at around 5% of GDP. The size of the planned fiscal gap for 2013 is unlikely to satisfy the IMF, which insists on tough fiscal austerity to adjust for existing macroeconomic imbalances. Assuming Ukraine eventually reaches a new agreement with the IMF, we forecast the fiscal deficit will be reduced to about 4% of GDP in 2013.

Monetary Policy

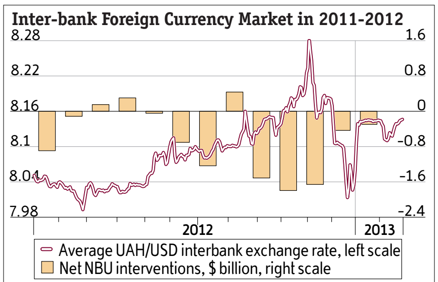
Following 0.2% yoy deflation in 2012, Ukraine continued to enjoy low consumer price growth in the first month of 2013. The annual price index remained 0.2% yoy lower in January 2013 mainly thanks to continuing food price deflation (down by 2.2% yoy) and a modest increase in utility tariffs (up by 0.6% yoy) as the government kept delaying raising natural gas and heating costs for the population. Downward pressure on food prices was exerted by oils and fats, sugar, fruit and vegetables. Significant declines in their inflation rates were the result of a plentiful harvest of sugar beets, sunflower seeds, fruit and vegetables for the second year in a row.[2] Ample grain harvest also affected the costs of animal feed, which spilled over into prices for meat and meat products. In January 2013, inflation in this sub-component decelerated to 0.9% yoy. Post-election adjustment of some regulated prices was likely the principal reason of a 3.3% yoy increase in bread prices. Due to tepid global growth and improving supplies, the dynamics of world energy prices remained subdued. As a result, domestic fuel prices continued to decelerate in annual terms and were 6.4% yoy higher in January 2013.

Consumer Inflation



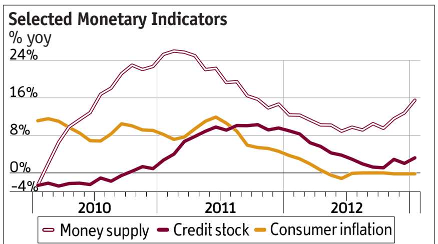
Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Inter-bank Foreign Currency Market in 2011-2012



Source: Finance.ua, NBU, The Bleyzer Foundation

Selected Monetary Indicators



Source: State Statistics Committee, NBU, The Bleyzer Foundation

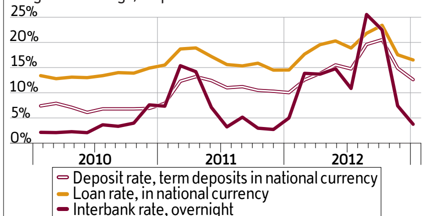
The coming months are unlikely to deliver a similar inflation pattern. Acceleration in expected starting in summer amid a low base effect and eventual increases in energy prices for the population. The latter is likely to remain among the key condition for the IMF bailout loan. In January, the Ukrainian prime minister signaled that the government might step back from its previous intention to keep energy prices unchanged by announcing that prices may be increased for wealthy households. At the same time, the relaxation of the IMF conditionality might be expected only if Ukraine will progress in negotiations with Russia to revise the price formula for imported natural gas from Russia. So far, as there is no evident progress in these talks, the government is likely to initiate a gradual tariff adjustment over the course of the year. Coupled with the low base of the previous year, this will drive consumer inflation to about 8% yoy in 2013.

The impact of monetary expansion on inflation remained subdued, although the pace of growth of monetary aggregates

[2]Ukraine collected a record high harvest of raw vegetables in 2012. The 2012 crop of sunflower seeds was the second highest in history, while the harvest of sugar beets was the second largest in 15 years.

slightly accelerated in December 2012 and January 2013. In particular, the annual growth rate of the monetary base advanced to 6.4% yoy and 9.5% yoy in December and January respectively, up from 3.3% yoy in November 2012. This increase primarily reflected significant loosening of fiscal expenditures at the end of the year, as well as eased depreciation pressures on the foreign exchange market. Thus, cash balances on government correspondent accounts with the NBU declined from UAH 13.5 billion ($1.7 billion) in November to less than UAH 1.3 billion in December. Despite recovering to UAH 6.8 billion in January 2013, cash balances were almost twice lower than in the corresponding period last year. In January, there was also a strong increase in NBU holdings of government securities.

Interest Rates in Ukraine
weighted average, % pa



Source: NBU, The Bleyzer Foundation

With regard to the foreign exchange market, administrative restrictions on foreign currency trade introduced in November reduced population demand for foreign currency and increased the supply of foreign currency (the mandatory sale of 50% of export earnings was enforced in mid-November 2012). Improved public and private debt inflows (issuance of sovereign Eurobonds in November 2012 and state-run Ukreximbank Eurobonds in January 2013) as well as the issuance of government securities in foreign currency also helped to calm Hryvnia depreciation pressures. Although the NBU continued supporting the Hryvnia peg to the US Dollar through indirect forex interventions (via state-owned banks), the scale of interventions notably declined in December 2012 and January 2013. As a result, the Hryvnia appreciated to UAH 8.0 per USD by the end of 2013, a roughly 3.7% gain compared to mid-November's highs, but returned to UAH 8.13-8.16 per USD in January after the holidays.

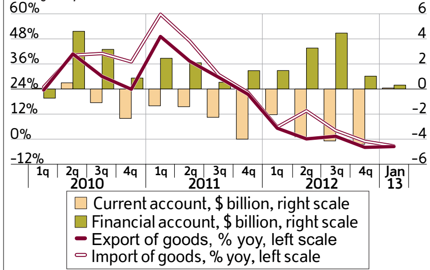
The near-term outlook for the Hryvnia exchange rate remains favorable, supported by additional placement of sovereign Eurobonds in February (which fully cover the redemption payments to the IMF that month) and resumed negotiations on the new IMF bailout loan. Although the IMF left Ukraine in February without signing an agreement, the mission is expected back in March, while the loan agreement may be completed by this summer. In the longer term, widening external imbalances amid shrinking international reserves shows the current exchange rate regime is not sustainable. The question is only whether there will be an orderly or an abrupt adjustment. With the IMF deal, we forecast moderate and controlled devaluation of the Hryvnia in 2013.

Depreciation expectations together with Hryvnia supply constraints during most of 2012 may explain the high interest rate differential between deposits in local and foreign currencies. On a positive note, the high deposit rate stimulated the growth of deposits. Local and foreign currency deposits accelerated to 17.6% yoy and 20.2% yoy in January 2013, respectively. On the downside, the high deposit rate and risk perceptions keep the lending rate high. Coupled with tight Hryvnia supply over 2012 and banks' ongoing balance-sheet repair, this underpinned weak credit growth. The stock of bank loans grew by 2.1% yoy in 2012 and only slightly accelerated to 3.2% yoy in January 2013. In addition to the above-mentioned reasons, credit growth was affected by a revision of market strategies of many European-owned banks in Ukraine. The shaky position of their parent banks amid a weak economic outlook for Ukraine prompted downsizing of business activities and/or exit from the country. While these developments will partially be offset by expansion of domestic banks, lending activity is forecast to remain frail also in 2013.

International Trade and Capital

A weak external trade environment continued to weigh on Ukrainian export dynamics. In December 2012, the decline in exports of goods worsened to 13.6% yoy. In addition to poor metallurgical and machinery exports (down by 31% yoy and 5% yoy respectively), such export dynamics might have been the result of lower shipments of agricultural products. Aggressive grain exports partially offset weaknesses in traditional exporting commodities in the previous months. However, concerned over sufficiency of wheat supplies for the domestic market, the Ukrainian government urged grain traders to restrain wheat exports at the end of November. Furthermore, due to ongoing depression in domestic oil-refining and downward adjustment of world fertilizer prices, exports of these commodities edged down by 44% yoy and 31% yoy respectively. Overall, merchandise exports grew by a meager 0.5% yoy in US Dollar value terms in 2012.

Ukraine's Balance of Payments Performance
analytic presentation



Source: NBU, The Bleyzer Foundation

In contrast to exports, imports resumed growth in December, advancing by 0.9% yoy, which may be principally attributed

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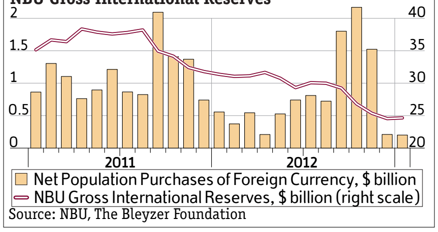
to an 11% yoy increase in imports of transport vehicles and other machinery. For the year 2012, imports rose by 5.3% yoy. The notable deceleration from 41% yoy in 2011 was the result of Ukraine's policy to reduce its energy import dependency as well as subdued domestic investment demand. In particular, natural gas supplies to Ukraine were reduced by 26.5% yoy to 33 billion m3 in 2012. On the upside, rallying domestic consumption kept fuelling imports of machinery and transport vehicles and food products (up by 12% yoy and 18.5% yoy respectively).

Population Demand for Foreign Currency and NBU Gross International Reserves



Source: NBU, The Bleyzer Foundation

As imports grew faster than exports, the current account gap widened sharply to $14.4 billion or about 8.2% of GDP in 2012, a new high for Ukraine. Such a significant widening (from 5.5% of GDP in 2011) clearly indicated the severity of external imbalances of Ukraine and, coupled with high external debt financing needs, contributed to Hryvnia depreciation pressures at the end of 2012. Somewhat slower domestic consumption growth and government policy to reduce energy imports[3] will contain large increases in the current account deficit in 2013. At the same time, due to the authorities' reluctance to shift to a more flexible exchange rate regime, the adjustment will be slow. In 2013, we project the current account deficit to narrow to around 7% of GDP.

Early foreign trade data for the first month of 2013 was in line with these expectations. Imports fell by 3.3% yoy amid lower energy supplies and investment goods. Although exports continued to decline too (down by 3.5% yoy), they improved compared to the previous month. As a result, the current account switched to a slight surplus. Typical for the beginning of the year, the surplus was almost 3 times lower than in the respective month last year.

Financial account developments were rather favorable during the first month of 2013. Despite the absence of IMF financing, Ukraine was able to attract sufficient external funds to cover its external financing needs. In particular, Ukraine has placed an additional $1 billion of 10-year Eurobonds issued in November 2012, while NBU administrative restrictions on foreign currency trade and other efforts to support Hryvnia exchange rate calmed population demand for foreign exchange. In January 2013, net population purchases of foreign currency stood at only $0.2 billion compared to $0.6 billion in January 2012 and $1 billion on average for the last six months of 2012. This allowed the NBU to not only continue maintaining the Hryvnia exchange rate peg but also slightly augment gross international reserves to $24.7 billion as of end-January 2013.

Despite an encouraging start, Ukraine's external imbalances remain large in 2013. In addition to the current account deficit, which is forecast to stay high despite some improvement compared to the previous year, Ukraine is facing significant external debt repayment requirements. In previous few years, Ukraine's external debt financing requirements were principally formed by banking and corporate sectors' roll-over needs. In 2013, public debt repayments will represent a significant component of the total external financing need principally due to maturity of $5.5 billion of IMF loans and $1 billion of Eurobonds. High external financing requirements bear significant risk for economic development of Ukraine given uncertain foreign capital markets and gross international reserves staying below three months of imports. Although Ukraine successfully accessed the Eurobonds market in 2012 and financing conditions on international markets have been gradually improving, Ukraine is unlikely to cope with its funding needs without IMF financing.

The mission came to Ukraine at the end of January-beginning of February 2013 to evaluate the current economic situation and discuss structural adjustment policies. Additional placement of $1 billion Eurobonds at the beginning of February 2013 gave the Ukrainian authorities some time to negotiate a new IMF loan, which is now expected to be approved this summer. Raising natural gas tariffs to the population, fiscal consolidation and a more flexible exchange rate regime are likely to remain among key IMF requirements. With the IMF deal, Ukraine will be able to cover its financing needs but due to the latter condition, the Hryvnia may moderately depreciate. Without the IMF agreement, Ukraine may experience sharp depreciation unless it secures sufficient financing on international borrowing markets (assuming their notable improvement in 2013) or reaches bilateral agreement with Russia.

[3] The government announced its plans to import around 20 billion m3 of natural gas from Russia in 2013, about 23% lower than a year before. The decline will partially be offset by gas supplies from the west, purchased at wholesale spot prices. In November 2012, Ukraine started natural gas imports from Europe under contract with German RWE at an average price about 5% lower than the price of Russian gas. However, due to technical obstacles (such as the need to simultaneously receive gas from Europe and to secure transit of Russian gas to Europe) gas imports from Europe are unlikely to be significant. Moreover, due to a 'take or pay' clause in the current gas contract between Russia and Ukraine, Russian Gazprom billed $7 billion for Ukraine importing less than contracted natural gas in 2012. Ukraine has challenged the bill as about 6 billion m3 was imported by a private trader, bringing the tally amount of natural gas imported from Russia to 33 billion m3 in 2012. Nevertheless, the future of the bill remains unclear adding to Ukraine's external financing uncertainties in 2013.

Additionally, the Ukrainian authorities are trying to increase domestic natural gas extraction. Besides investing into renovation and modernization of existing gas extraction capacities, in January 2013 the government signed a production sharing agreement with Royal Dutch Shell, which will explore and drill shale gas in Ukraine. Ukraine's shale gas reserves are estimated at 1.2 billion m3, the third largest in Europe. Although shale gas development is a rather long term endeavor, the deal with Shell may become an additional argument in talks with Russia to renegotiate the terms of the 10-year natural gas deal signed in 2009.

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