SigmaBleyzer

Ukraine
Macroeconomic Situation

THE BLEYZER FOUNDATION
Turning Transitions Into Prosperity

March 2013

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- **Real sector data was mixed for February 2013. Output contraction deepened in the industrial sector, construction and dependent sectors. On the upside, agriculture and retail sales demonstrated further gains.**
- **Economic weakness continued to take a toll on state budget revenues, while expenditures continued to grow at a fast pace. As demands on the state budget exceeded collected revenues for the first two months of the year, a deficit was incurred.**
- **Consumer prices fell by 0.5% yoy in February. Inflation is expected to stay within the 5-6% yoy target set forth by the monetary authorities.**
- **The growth of monetary aggregates accelerated slightly in February. However, so far it has had limited impact on both inflation developments and bank lending activity.**
- **External trade performance improved in February 2013 as export growth recovered while imports continued to contract, reflecting positively on the trade balance.**
- **Thanks to foreign investors' improving appetite for risk, Ukraine received sufficient foreign financing to service its external debt. As a result, Hryvnia depreciation pressures continued to subside in March.**

Executive Summary

Following an encouraging start to the year, February saw a further deterioration in the majority of real sector indicators, signifying that Ukraine's economy still remains weak. Industrial output shrank 6% yoy in February, hampered by ongoing weakness in external demand and domestic investment. Decreased production of electricity, machine building, oil refining and metallurgy contributed the most to the decline in industry. Despite relatively warm weather, construction volume dipped by about 15% yoy in February, mirroring a decline in investment activity. Weaker industrial and construction performance weighed on wholesale trade and transportation turnover.

On a positive note, the contraction in metallurgy lost momentum in February. In addition, retail sales edged up by 14.8% yoy over January-February. This suggests continuing solid growth in private consumption, boosted by a 9.6% yoy increase in real wages over the period. Agricultural output growth increased to 5.8% yoy over January-February amid further gains in animal breeding. However, improvements in these sectors were insufficient to offset the more substantial contraction in the industrial goods producing sector, construction and related sectors. As a result, the economy is likely to fall in 1Q 2013. As world demand is expected to gradually recover through 2013, the expansion in exports compounded with robust private consumption and the forecasted high agricultural harvest should pave the way for a return to growth in the second half of the year. Real GDP is projected to expand by about 2% yoy for 2013.

The consumer price index fell 0.5% from a year ago in February. Prices continued to benefit from favorable supply conditions in 2012 and the government freezing of natural gas tariffs for the population. At the same time, persistent deflation (for the fifth consecutive month) was also a reflection of weak economic activity. The growth of monetary indicators strengthened in February, although its impact on price development remains limited. Inflation is forecast to remain within the targets (4.8%-6.1% yoy at the end of 2013). Diminished inflationary and Hryvnia depreciation pressures allowed the NBU to balance between their two main goals– stimulating economic growth by providing sufficient liquidity to the banking sector and maintaining foreign exchange rate stability.

Weaker than expected economic conditions adversely affected budget revenue performance. Revenue collections were up by a nominal 5% yoy over the first two months of the year. At the same time, expenditures soared upward by 21% yoy over the period amid a strong increase in social security and safety benefits and higher public debt service payments. As a result, the state budget ran an early deficit, pointing to a deterioration of fiscal conditions over the first two months of the year. The deficit was covered by new government borrowings, a substantial portion of which was purchased by the National Bank of Ukraine. As revenue mobilization is likely to be challenging in the near term, in order to make up for the shortage in revenue, the government has initiated increases in excises taxes and import duties. While these efforts may help in the short run, more comprehensive measures to sustain public finances are required. In particular, Naftogaz remains a considerable drag on the fiscal situation in Ukraine, due to heavily subsidized natural gas tariffs for the population and heating companies. Although Ukrainian authorities have refrained from politically painful increases in tariffs, they seem to realize the urgency of energy sector reform. We also expect an extensive budget revision following the end of the first quarter of 2013.

External trade performance improved in February 2013, contributing to diminishing Hryvnia depreciation pressures. Following three months of contraction, exports rebounded, expanding by 8.1% yoy in February mainly on account of higher yields of metallurgical and agricultural products. As imports continued to decline (-7.5% yoy) amid lower energy imports, the monthly current account gap was notably lower in February 2013 compared to a year ago. Coupled with successful sovereign Eurobonds issuance and external debt inflows to the corporate sector, this allowed Ukraine to not only successfully meet its external financing needs in the absence of IMF financing but also to slightly augment its gross international reserves.

Where Opportunities Emerge.

Chief Economist Edilberto L. Segura
Editor Rina Bleyzer O'Malley

March 2013

Though external sector imbalances remain high in Ukraine, recent external sector improvements and ongoing talks on IMF deal suggest Ukraine may secure sufficient external financing in 2013. Hence, Hryvnia may remain relatively stable during 2013.

	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	-3.0
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

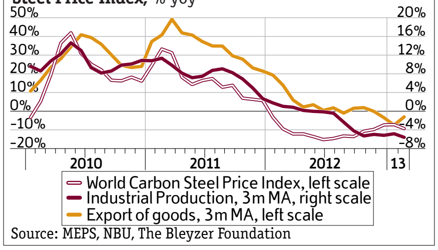
Following the encouraging start to the year, February's development of most real sector indicators was generally disappointing. In particular, the decline in industrial production deepened to 6% yoy in February, indicating that Ukraine's economy still remains weak. Production of electricity, gas and water shrank by 17.2% yoy, accounting for much of the decline in industrial output. Relatively warm weather in February caused a sharp drop in domestic demand for energy, partially offset by buoyant electricity sales abroad (exports grew by almost 50% yoy in February).Domestic machine-building, oil-refining and metallurgy, which together account for about 1/3 of total industrial production[1], kept decreasing productivity, suffering from low investment, tight import competition and infrastructure bottlenecks, as well as the consequences of soft global commodity prices. Output production in these industries was down11.4% yoy, 22.1% yoy and 6.6% yoy respectively.

Real Sector Performance of Ukraine
% yoy

	2013 2m	2013 1m	2012	2011
Agriculture	5.8	5.6	-4.5	17.5
Industrial output	-4.8	-3.2	-1.8	7.6
Construction works	-11.3	-7.6[*]	-13.8	11.1
Domestic trade turnover				
Wholesale trade	-5.2	-7.3	-4.4	0.6
Retail trade	14.8	14.2	15.9	14.7
Restaurants	6.5	6.1	8.2	11.0
Transportation turnover				
Cargo	-11.0	-13.0	-7.6	5.7
Passenger	-4.1	-4.4	-1.2	3.3
Services, non-financial	0.2	2.9	8.7	18.6

[*]Revised data
Source: State Statistics Committee

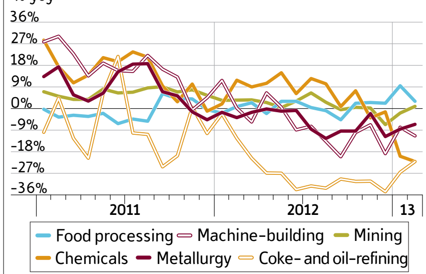
Ukrainian Industry and Exports of Goods, and World Steel Price Index, % yoy



Source: MEPS, NBU, The Bleyzer Foundation

Despite favorable climate conditions, the volume of construction projects fell by about 15% yoy in February, pointing to a protracted reduction in investment activity. Weaker construction and industrial sector performance weighed on wholesale trade and transportation. Turnover in these sectors fell by 5.2% yoy and 11% yoy respectively over January-February 2013. Chemical production also fell by 22% yoy in February as world fertilizer prices continued along a downward trend, although the high base effect of the previous year also had an impact on the industry's performance.

Industrial Production Growth by Select Branches
% yoy



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

On a positive note, the contraction in metallurgy slowed in February amid signs of rebounding steel demand in China and low steel product inventories. Robust external and strengthening domestic production of metallurgical products was underpinned by a 4.3% yoy rise in iron ores extraction. Retail sales, agriculture and food processing showed further gains over January-February. Retail sales turnover edged up by 14.8% yoy, which suggests continuing solid growth in private consumption, boosted by a 9.6% yoy increase in real wages over the period. Good crop harvests for two years in a row underpinned solid development in animal breeding. As a result, agricultural output growth sped up to 5.8% yoy over the first two months of the year. Closely linked to both agricultural performance and consumer demand, food processing production rose by 3% yoy in February. Improvements in these sectors, however, were insufficient to offset the ongoing contraction in the production of industrial goods, construction, wholesale trade, and cargo transportation. As a result, the economy is likely to decline in 1Q 2013.

As world demand is expected to gradually recover through 2013, the expansion in exports compounded with robust private consumption and the forecasted high agricultural harvest should pave the way for a return to growth in the second half of

[1]Estimate based on industrial sales.

the year. Moreover, in its efforts to stimulate economic growth, the government increased import duties on cars[2] and has initiated a large-scale revision of the import tariffs that it committed to upon its WTO entry[3]. Although trade restrictions cause efficiency losses for the country and may complicate bilateral and multilateral trade relations, in the short run they may enhance domestic production and reduce imports. To achieve a sustainable domestic supply response, however, these measures should be accompanied by improvements in the business and investment climate. All in all, real GDP is forecast to expand by about 2% yoy for 2013.

Fiscal Policy

Weaker than expected economic conditions (economic growth and inflation) adversely affected budget revenue performance. Revenue collections saw a nominal increase of 5.2% yoy over the first two months of the year. The growth was principally due to a 23% yoy increase in corporate tax proceeds, which may be explained by advance payments of this tax.[4] Customs duties and excises also accounted for the increase in budget revenues due to higher excise taxes and increased consumption. At the same time, the growth in proceeds from value added tax, which account for about half of total budget revenues, lagged far behind other taxes. Indeed, VAT collections were 5% yoy lower than in January-February 2012, which is quite surprising given the strong consumption. The decline may be explained by the contraction in wholesale trading as well as lower imports.

State Budget Execution for Jan-Feb 2013

	% of total	% yoy
Total Revenues	**100**	**5.2**
VAT collection	48.1	-5.1
VAT refund	-16.2	20.7
Corporate Profit Tax	25.9	23.1
Excises	9.4	28.2
Import duties	3.2	13.0
Expenditures	**100**	**20.9**
Social security and safety	25.3	44.6
Debt service	7.8	43.2
Economic activity	8.4	9.4
Transfers to local budgets	30.5	10.6

Source: Ministry of Finance, The Bleyzer Foundation

In contrast, expenditures increased dramatically by 21% yoy over the period amid a strong increase in social security and safety benefits (up by 45% yoy) and higher public debt service payments (up by 43.2% yoy). The increase would have been much higher had the state not carried out its usual practice of under-executing expenditures at the beginning of the year. As expenditures grew much faster than revenues, the state budget ran a UAH 2.3 billion deficit over the first two months of 2013 compared to a UAH 4.7 surplus over the respective period last year.

The first two month deficit was covered by new government borrowings. In particular, taking advantage of loose liquidity on international financial markets and the improved risk appetite of investors, the government placed an additional $1 billion to its 10-year Eurobonds issued in November 2012. The majority of funds, however, were attracted on the domestic market. At the same time, demand for domestic securities was relatively low. As a result, the National Bank of Ukraine was among the main buyers of domestic securities. In particular, the amount of domestic debt securities in the NBU portfolio grew by 6.5% in January and 5.1% in February, signaling the indirect monetization of its fiscal deficit. All of this indicates growing fiscal pressures.

In addition, revenue mobilization may be a challenging task in the near term. In particular, the collection of profit taxes may face setbacks over the coming months In March, taxpayers will accrue tax based on profits earned for the whole year (economic conditions deteriorated sharply from June to December last year, while solid growth in 1H 2012 created a favorable basis for profit tax payments in January-February). Starting April 1st, corporate profit tax will be reduced by 2 percentage points to 19%. The government is counting on additional revenues from higher import duties and plans to raise excises on alcohol and tobacco. While these efforts may help in the short run, more comprehensive measures to sustain public finances are required. In particular, Naftogaz remains a considerable drag on the fiscal situation in Ukraine, as the company runs persistent deficits due to heavily subsidized natural gas tariffs for the population and heating companies. Although the Ukrainian authorities have refrained from politically painful increases in tariffs, they seem to realize the urgency of energy sector reform. At the end of February, the government hired a well-known international consulting firm to develop a reform plan for the company. While an increase in natural gas prices is unlikely to be avoided, these measures may allow for their gradual adjustment, which is preferable for the authorities. So far, however, we expect an extensive budget revision following the end of the first quarter of 2013.

[2]New tariffs ranging from 6.5% to 13% will be imposed in addition to the existing 10% import duty on cars and will come into effect in mid-April 2013.

[3]In September 2012, the Ukrainian authorities announced would renegotiate the tariff ceiling on 371 goods. While the WTO rules in principle allow such a practice, the number of requested tariff revisions is unprecedented and has already raised concerns that such move may cause a new wave of global protectionism.

[4]Starting in 2013, the mechanism of paying the corporate profit tax was changed. In particular, the corporate profit tax return is submitted once for the year (each quarter before). At the same time, the taxpayers should pay 1/12 of the profit tax of the previous year from March to the rest of the year and 1/9 of the profit tax accrued for the first nine months of the previous year.

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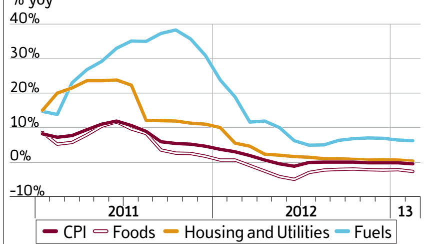
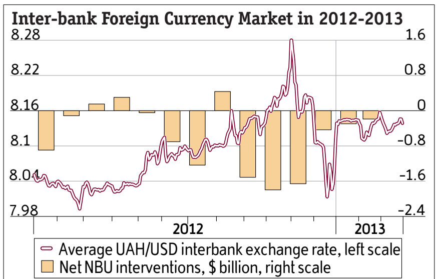
Monetary Policy

The consumer price index fell 0.1% in February compared to the previous month and 0.5% from a year ago. Prices continued to benefit from favorable supply conditions in 2012 and government freezing of natural gas tariffs for the population. In particular, food prices were 2.7% yoy lower in February, while housing and utility services price inflation declined further to 0.3% yoy. A favorable base effect and falling world crude oil prices drove domestic fuel prices downwards. At the same time, persistent deflation (for the fourth consecutive month) was also a reflection of weak economic activity. Subdued price growth over the first two months of the year and a delay in utility tariff adjustments led us to revise our year-end inflation forecast down to 5-6% yoy in 2013.

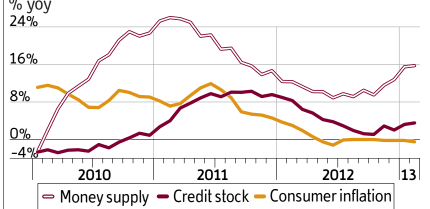


Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

The growth of monetary indicators strengthened in February, although its impact on price development remains limited. The annual growth of the monetary base sped up to 11.6% yoy in February amid improved banking sector liquidity, large NBU purchases of government securities and a reduction in government cash balances with the NBU. The holdings of deposits by corporate enterprises and households continued to grow, expanding to 19.4% yoy in February. Households made the largest contribution to the increase, although their annual growth rate moderated to 18.5% yoy. The deceleration was due to declining preferences for deposits in foreign currency amid calmed Hryvnia depreciation pressures, low domestic inflation and attractive deposit rates. Stronger growth of the monetary base and deposits supported an increase in the money supply to 15.7% yoy in February. At the same time, lending to the private sector remains weak as the stock of loans expanded by a mere 3.5% yoy over the period.



Source: Finance.ua, NBU, The Bleyzer Foundation



Source: State Statistics Committee, NBU, The Bleyzer Foundation

As inflation is forecast to remain within the targets (4.8%-6.1% yoy at the end of 2013[5]), the monetary stance is expected to remain accommodative. By managing liquidity provisions, the monetary authorities will try to find a balance between their two goals – stimulating economic growth and maintaining foreign exchange stability. These goals often conflict with one another, as the NBU should provide sufficient liquidity for the banking sector to spur bank lending to the private sector. At the same time, ample liquidity amid high deprecation expectations adds to exchange rate pressures. In 2H 2012, the National Bank of Ukraine squeezed banking sector liquidity, in addition to forex market interventions and administrative restrictions, to maintain the Hryvnia peg to the US Dollar amid strong depreciation pressures. Coupled with the deteriorating external environment, this contributed to weakening economic growth as tight liquidity coupled with a high credit risk hampered credit growth.

Over the first three months of 2013, Hryvnia depreciation pressures receded. Supported also by continuing NBU interventions (though on a much lower scale than at the end of 2012), the exchange rate fluctuated within a relatively narrow margin of UAH 8.11-8.14 per USD. This allowed for loosing the liquidity stance in an attempt to stimulate bank lending.

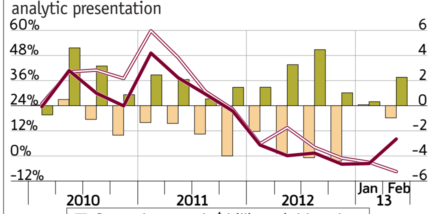
International Trade and Capital

External trade performance improved in February 2013, contributing to diminishing Hryvnia depreciation pressures. Following three months of contraction, exports rebounded to growth, expanding by 8.1% yoy in February mainly on account of higher supplies of metallurgical and agricultural products. Although the low base effect of the previous year was likely the principal reason for the 3.1% yoy increase in exports of metallurgical products in February, strengthening steel consumption in Asia (e.g., China and India) also had a positive impact. Thanks to high agricultural harvests of the previous year, earnings from export of grains and food products rose by 31.5% yoy over the month. Rather surprisingly, export of machinery and transport vehicles edged up by 5% yoy in February, which may be attributed to a favorable base of comparison.

In contrast, imports declined 7.5% yoy in February principally due to lower energy imports, which slumped by almost 40%

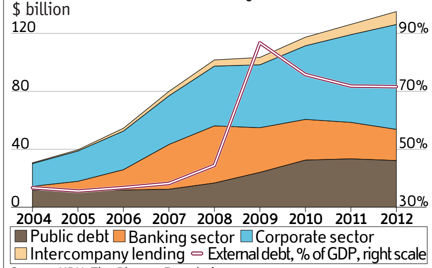
[5]According to Main Principles of Monetary Policy for 2013.

yoy. On the upside, robust consumption and government plans to introduce additional import duties on transport vehicles underpinned a 28.6% yoy and 1.2% yoy increase in food products and machinery imports. In addition, supplies of chemical goods went up by 19.5% yoy amid a surge in domestic demand for imported drugs amid population fears that the new licensing requirement effective in March may cause a shortage of foreign-produced medicines on the domestic market.



Source: NBU, The Bleyzer Foundation

As a result, the monthly current account gap stood at about $1 billion in February 2013, 40% lower than a year ago. Coupled with successful sovereign Eurobonds issuance and external debt inflows to the corporate sector, Ukraine was able to not only successfully meet its external financing needs in the absence of IMF financing but also to slightly augment its gross international reserves. Despite somewhat eased Balance of Payments pressures over the first two months of the year, external sector imbalances remain high in Ukraine. Thus, the current account deficit is forecast at around 7% of GDP in 2013. Furthermore, the high fiscal deficit and external debt financing needs amid turbulent international financial markets make Ukraine vulnerable to an adverse shift in market sentiment. Public external debt financing needs alone are estimated at around $8 billion in 2013, while total external debt financing needs amounted to $61 billion as of the beginning of 2013.



Source: NBU, The Bleyzer Foundation

On a positive note, diminished Hryvnia depreciation pressures and administrative restrictions on forex purchases calmed population demand for foreign currency. Over January-February, net population purchases amounted to $0.4 billion, almost 55% lower than in the corresponding period last year. In addition, external financial market conditions seem improving as Ukraine successfully made several private and sovereign Eurobond placements. Given improved investors' risk appetite and ongoing negotiations on IMF deal, we now project Hryvnia to remain virtually stable in 2013.

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