Ukraine's Macroeconomic Situation and Outlook

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Summary

The Ukrainian economy grew fast during 2000-2007, was hit hard by the 2008 global financial crisis, and showed strong recovery in 2010 and the first-half of 2012. But in the second-half of 2012 and early 2013, Ukraine's exports and export-dependent sectors were negatively affected by the deterioration in Ukraine's external environment related to persisting economic weaknesses in the EU, one of Ukraine's largest trading partners, and weakening world commodity prices. However, thanks to buoyant private consumption, underpinned by solid real wage and pension growth and diminished inflationary pressures, real GDP avoided a decline for the year 2012 and is forecast to increase by 1% in 2013. With stronger recovery of foreign demand, Ukraine is projected to gain momentum from the second half of 2013 and grow by 3%-4% yoy next year.

Over the medium term, Ukraine's GDP should be able to rise by about 4%-5% pa with growth driven by strong private consumption, increasing exports and reduced imports. On the supply side, the agricultural sector may become a driver for real GDP growth, if followed by larger investments in fertilizers, modern agricultural machinery, seeds, and managing practices.

Moreover, Ukraine may be able to achieve and sustain even higher growth rates of 5% -7% pa, which were achieved in the 2000's. Indeed, Ukraine has a good potential to become the growth leader in the region again thanks to its large consumer market with a population of over 45 million, an educated and relatively cheap labor force, fertile land and favorable climate, one of the largest potential supplies of shale gas in Central and Eastern Europe, and favorable geographic location at the cross-roads of trade flows to Asia and the EU. But to unlock this potential, the country needs to proceed with business and investment climate improvements. A Free Trade Agreement with the EU may become a good trigger for enhanced reform progress in Ukraine as it was for many Eastern European countries.

Since the 2008-09 crises, Ukraine has achieved good economic progress in a number of areas. Inflationary pressures were reduced, with inflation reaching an historical low in 2012. The government's fiscal budget deficit was tightened from about 8.5% of GDP in 2009 to 4.3% of GDP in 2011, and is forecast to narrow further to 4% in 2013 and to 3% in 2014. The reductions in fiscal deficits have allowed Ukraine to bring its public debt to GDP ratio down. Internal and external public debt is now expected to stabilize at around 35% of GDP over the medium term.

Following severe money supply tightening in the aftermath of the crisis, monetary conditions have been improving since the end of 2012 and are expected to be gradually reflected in credit growth. Thanks to government measures to stimulate exports and contain energy imports, external imbalances should narrow to a more sustainable level over the medium-term. Although Ukraine's external debt financing needs are high, since 2009, the country's gross external debt-to-GDP ratio declined by almost 14 percentage points to 75% of GDP in 2013. Since late 2012, Ukraine has been receiving solid foreign capital inflows, benefiting from loose international liquidity and a recovery of foreign investors' risk appetite for emerging markets. This trend is likely to be sustained in the future by prospects of an IMF loan extension and signature of a Free Trade Agreement with the EU.

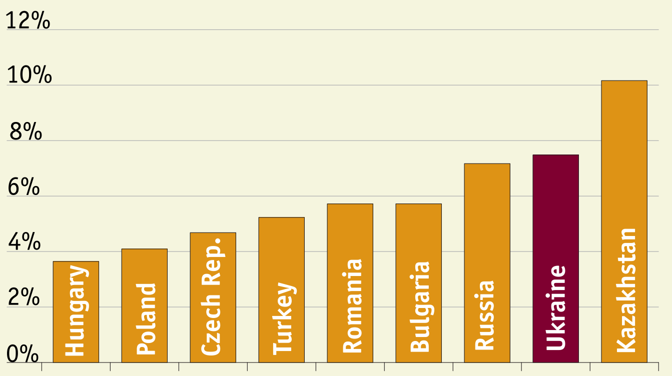
Thanks to lower inflation levels compared to Ukraine's main trading

partners, estimates of purchasing power parity point to reduced depreciation pressures on the Hryvnia exchange rate. Amid better fundamentals, forecast improvement in Ukraine's Balance of Payments and stronger population confidence, the Hryvnia exchange rate is forecast to remain relatively stable over the next few years, with a maximum devaluation of about 5%.

A. Economic Growth

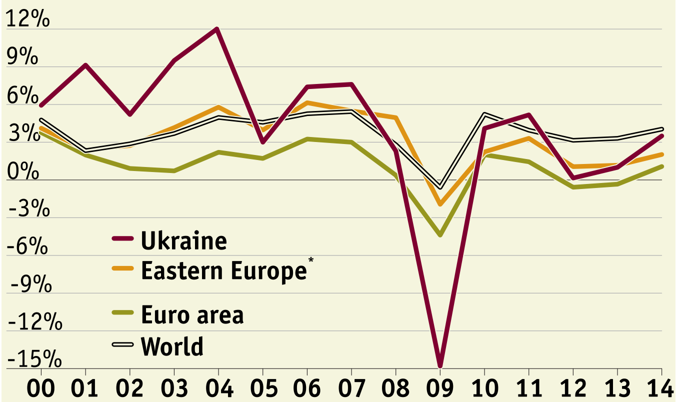
For several years until the fall of 2008, Ukraine enjoyed remarkable economic performance. With average real GDP growth of 7.5%, the country compared favorably to other Central and Eastern European countries.

Real GDP Growth in Selected Emerging Market Economies, 2000-07 average, %



Source: IMF World Economic Outlook Database (April 2013), The Bleyzer Foundation

Real GDP Growth, % yoy



**The region's GDP growth is a weighted average of growth rates in Bulgaria, Hungary, Poland and Romania.*
Source: IMF World Economic Outlook Database (April 2013), The Bleyzer Foundation

Initially, this performance was spurred by the strong depreciation of the national currency during the financial crisis in 1998-1999, a healthy external environment (thanks to high world commodity prices, exports were the main drivers of GDP growth in 2002-04), low energy prices, and significant progress in many areas of structural reforms during 1996-98 and 2000-04. An accumulated critical mass of economic changes by the mid-2000's allowed the country to continue growing at robust pace during 2005 up to late 2008, despite a number of adverse developments, such as political turbulence, several imported energy price shocks and a less benign environment for commodity exports in 2005-06.

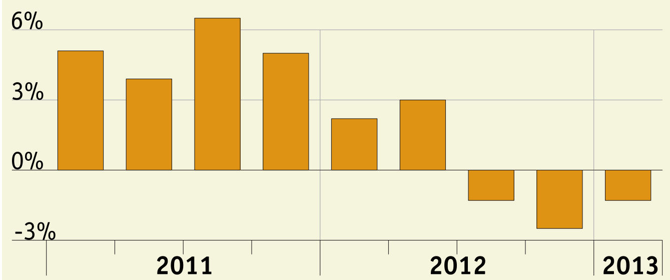
Since the mid-2000's, however, the reform progress has slowed down as economic policies have lacked consistency. Demand and consumption were encouraged via loose fiscal and monetary policies, while the weaknesses on the supply-side were not adequately addressed. Although buoyant consumption also stimulated imports, resumed growth in world commodity prices and ample foreign capital inflows masked the need for macroeconomic adjustment measures.

As a result, at the onset of the world liquidity crisis in 2008, Ukraine had accumulated a number of vulnerabilities (high dependence on undiversified exports, rising current account deficits, increasing external short-term indebtedness of banks and corporations, and growing weaknesses of the banking system on the back of rapid credit expansion and inadequate credit standards for borrowers). These vulnerabilities left the Ukrainian economy exposed to adverse shocks. Ukraine was severely hit by a sharp decline in world commodity prices and foreign demand and an abrupt reversal of foreign capital inflows in 2008-09.

The country, however, handled the crisis relatively well, to a great extent thanks to IMF and World Bank loans at the end of 2008. The broad structural reform program partnered with IMF loan conditions allowed Ukraine to resume growth in the second half of 2009 and grow by a healthy 4.6% per annum on average over 2010-11. However, as growth was restored, the willingness of the Ukrainian authorities to proceed with politically challenging structural transformations weakened, causing a suspension in IMF financing. Moreover, although some of the existing vulnerabilities were reduced (e.g., in the banking sector through the execution of bank recapitalizations and the introduction of restrictions on foreign currency loans, and in the current account with a sharp narrowing of the deficit), Ukraine remained exposed to adverse external environment shocks due to its high economic openness and slow domestic supply response amid a complicated investment climate.

Thus, in the second half of 2012, economic growth in Ukraine was severely affected by the cooling of overseas demand following the recession in the Eurozone, tight domestic credit conditions and a reduction in public investment after the completion of large infrastructure projects related to the Euro-2012 football championship. At the same time, thanks to solid growth in the first half of the year and resilient private consumption, a decline in GDP was avoided with the economy growing by 0.2% yoy in 2012. As economic headwinds also extended into the beginning of 2013, Ukraine's real GDP contracted in 1Q 2013. Quarterly data, however, suggests that economic activity may have already bottomed out. Moreover, survey indicators of business expectations continued to improve in 1Q 2013, pointing to stabilization in 1Q 2013 and a recovery to growth expected in the second half of 2013.

Quarterly Real GDP growth in Ukraine, % yoy



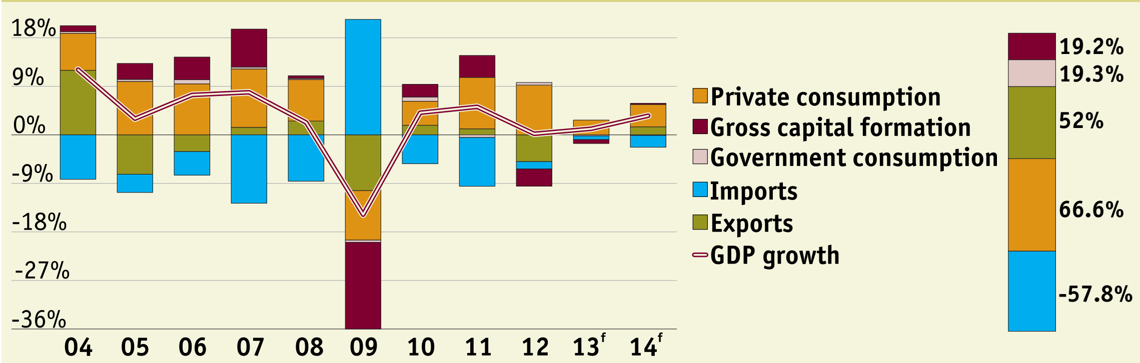
Source: SSS of Ukraine

B. Real GDP by Demand Components

1. Exports

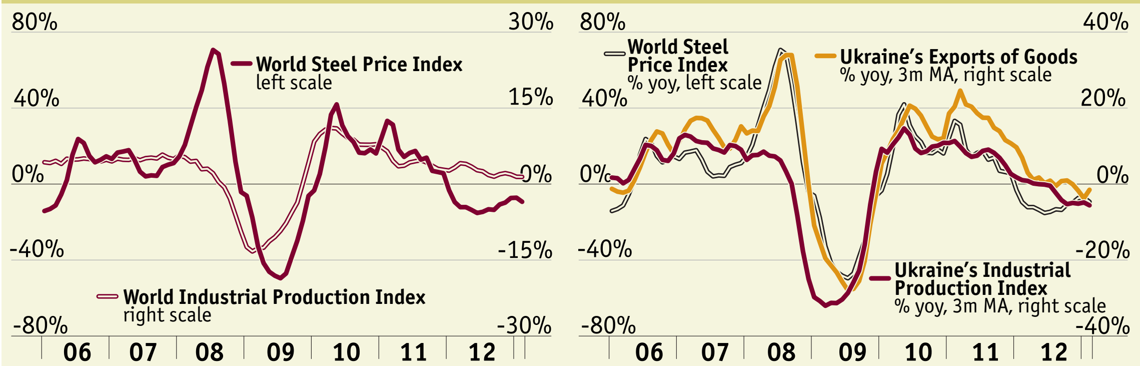
Since mid-2012, Ukrainian exports have suffered from weak foreign demand and declining world commodity prices. Exports' contribution to real GDP growth turned negative in 2012 and was among the principal reasons for output contractions in a number of export-related sectors, such as manufacturing, wholesale trade and cargo transportation.

Contributions to Real GDP Growth by Demand Component, percentage points, **and Real GDP Structure,** 2010-12, % of total



Source: SSS of Ukraine, The Bleyzer Foundation

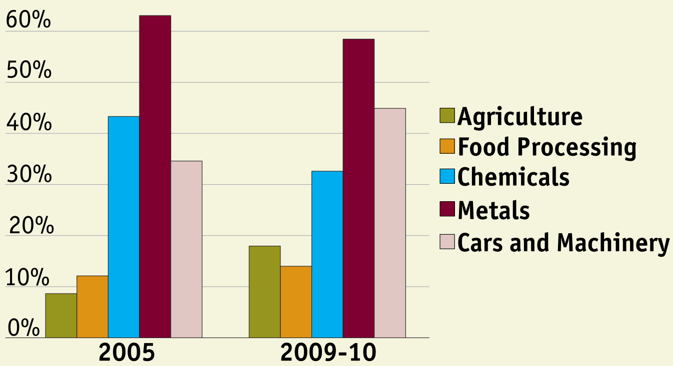
Evolution of World Steel Prices and Their Impact on Ukraine's Exports of Goods and Industrial Production



Source: MEPS, The CPB World Trade Monitor (Feb 2013), SSS of Ukraine, The Bleyzer Foundation

In principle, high dependence on exports should not be a problem for any country; but Ukraine's exports are relatively narrowly diversified by product and trading partner. Indeed, exports of metals account for more than 40% of total merchandise exports. As a result, exports and industrial production performance are closely related to world steel price developments. As for any low value added commodity, global demand and prices tend to fluctuate significantly over the course of global business cycles.

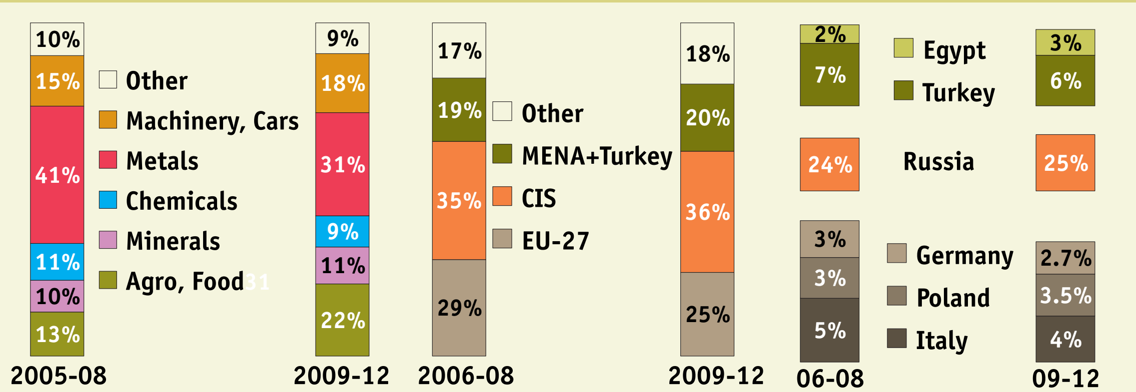
Share of Exports in Output Production of Selected Industries, 2006-12



Source: Input-Output Tables of Ukraine for 2005, 2009, 2010; The Bleyzer Foundation

Exports of high value added machinery, equipment and transport vehicles account for about 17% of total exports. However, its narrow geographic diversification, with more than 70% of this commodity group's exports going to Russia and other CIS countries, makes it vulnerable to the economic performance in these countries and changes in bilateral economic relations. In particular, cooling trade relations with Russia exerted a toll on Ukraine's export performance in 2012 and the beginning of 2013.

Ukraine's Exports by Commodity and Key Regions, % of total



Source: State Statistics Service of Ukraine, NBU, The Bleyzer Foundation

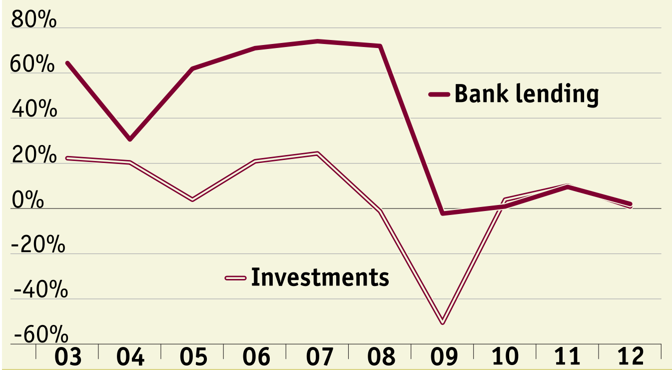
2. Investment

Rapid economic growth over 2000-08 and hopes of fast and broad-based economic transformation after peaceful resolution of the political crisis of 2004 spurred foreign investors' interest and foreign capital inflows to Ukraine through 2008. With the entry of many foreign banks and loose domestic and international liquidity, the banking sector of Ukraine experienced spectacular expansion with lending activity growing by about 70% per annum on average during 2005-08. Improved financing conditions stimulated a pick-up in investment activity, which became an important driver of economic growth over the period.

The global financial crisis of 2008 significantly affected the growth of credit. First, Ukrainian banks' access to international credit markets, the main source of credit expansion in the past, tightened in late 2008. This coincided with a high foreign debt re-payment burden for Ukraine's banking sector. Second, economic downturn and currency depreciation caused a deterioration in banks' asset quality, already weakened by rapid previous credit growth in the pre-crisis years. Third, domestic liquidity tightened significantly, reflecting foreign capital outflows, deposit withdrawals and increased demand for cash. As a result, bank lending activity shrank in 2H 2008-09 and remained subdued over the next few years due to increased risk aversion, ongoing deleveraging and continuing cleanup of bank balance sheets. In turn, tight money and credit conditions dampened investment activity. At the same time, increased public spending on several large infrastructure projects in the run-up to the Euro 2012 football championship supported a slight pick-up in fixed asset investment during 2010-1H 2012. However, following the completion of these projects and the need to consolidate public finances, gross fixed capital formation lost momentum in 2H 2012.

Banks' financial conditions have been improving since the end of 2012 thanks to easing money supply and foreign investors' revived risk appetite amid loose international liquidity. This should translate into future credit growth, although this is likely to be gradual. As a result, both credit growth and gross fixed capital formation growth rates are forecast to remain subdued in 2013-14.

Gross Fixed Capital Formation and Bank Lending Growth, % yoy



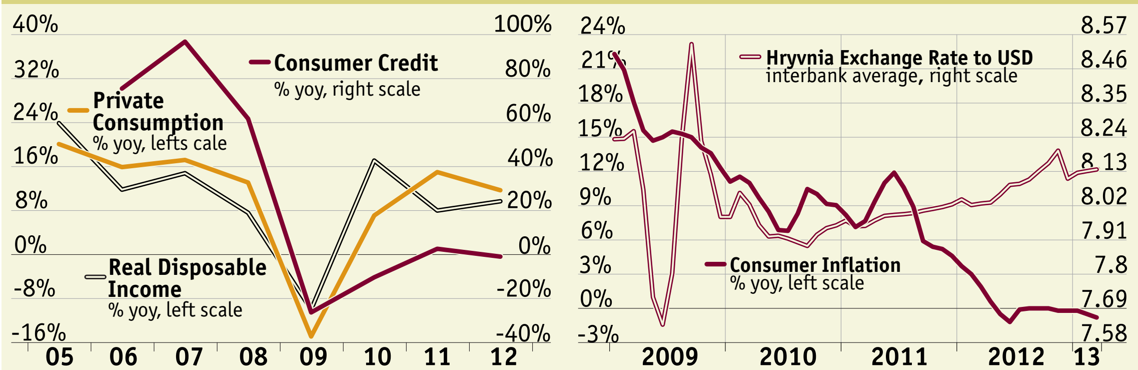
Source: SSS of Ukraine, NBU, The Bleyzer Foundation

3. Private Consumption

On the upside, private consumption became the leading factor contributing to GDP growth since 2005, fuelled by strong growth in real disposable income of households and booming credit. Indeed, real households' disposable income rose at about 17% per annum on average over 2005-07, reflecting strong increases in real wages and social benefits, while consumer credit grew by over 80% yoy on average during 2006-08. Although consumption contracted sharply in 2009, it rebounded strongly in 2010 and maintained solid speed in 2011-12. While consumer credit has been weak since 2009, gains in private consumption expenditures reflected improvement in household confidence amid rising wages, diminished inflationary pressures and a relatively stable Hryvnia exchange rate.

Consumption is likely to remain the main GDP driver in the medium-term. Anticipated fiscal consolidation may have a rather limited impact on household consumption, as the government is likely to keep the wage bill and pension spending high at the expense of capital investment.

Drivers of Private Consumption, % yoy



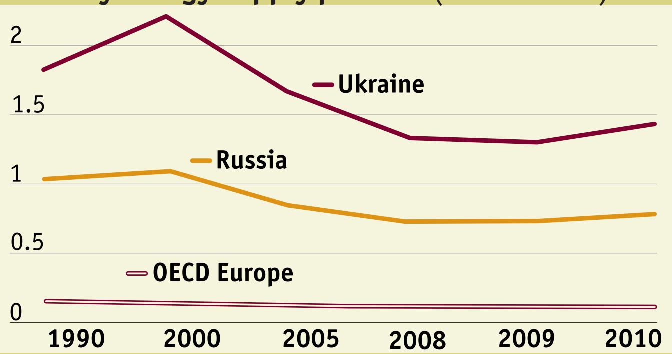
Note: Consumer credit growth estimate for 2006
Source: State Statistics Service of Ukraine, NBU, The Bleyzer Foundation

4. Imports

Buoyant domestic demand triggered rapid growth in imports during 2005-2011, excluding an abrupt contraction in 2009. In real terms, imports grew by 14% per annum on average during this period. As imports expanded faster than exports, the impact of foreign trade on GDP growth was negative. Following a temporary slump in 2009, the growth in imports resumed amid a rebound in economic activity. To a notable extent, however, the rise in imports reflected the high energy intensity of the Ukrainian economy amid a relatively low domestic energy endowment, particularly natural gas and crude oil.

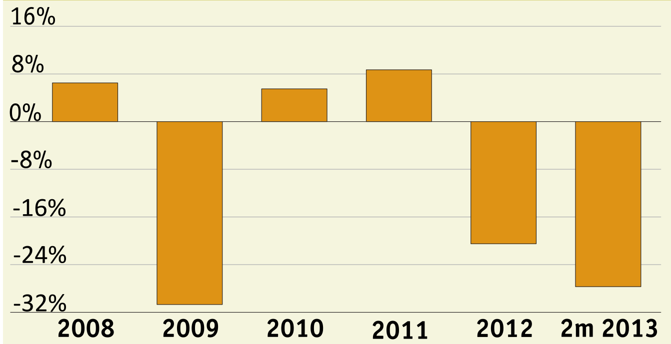
During Soviet times and for fifteen years since independence, the Ukrainian economy benefited from low energy costs. Cheap energy offered little incentive for Ukrainian enterprises to modernize outdated and highly energy-intensive production capacities and introduce energy saving technologies. However, several energy price shocks and the unfavorable natural gas contract signed with Russia have prompted the Ukrainian authorities to diversify energy supplies, encourage expansion of domestic energy extraction and stimulate investment into energy-saving technologies. As a result, the physical volume of energy imports declined by about 20% in 2012 from the previous year, according to the State Statistics Service of Ukraine. Moreover, the trend deepened at the beginning of 2013 as the volume of energy imports was down by about 28% in January-February compared to the corresponding period last year.

Energy Intensity by Select Countries, Total Primary Energy Supply per GDP (in 2005 USD)



Source: IEA (2012), Energy Balances of Non-OECD Countries

Quantity Change in Ukraine's Energy Imports, % yoy



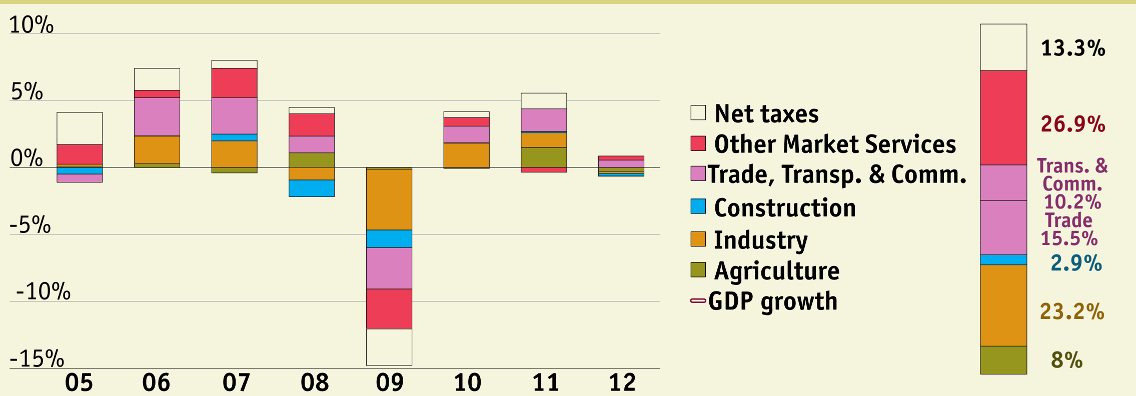
Source: SSS of Ukraine

In addition to measures reducing energy consumption, Ukrainian authorities have been taking steps to increase domestic production of energy resources. In particular, possessing one of the largest potential amounts of shale gas, Ukraine has recently entered into agreements with several major multinational oil companies to develop these deposits (Shell, Chevron, and Exxon Mobil). These agreements will help to sustain a continuing reduction in energy imports and support domestic economic growth by attracting large foreign investments into the extractive industry. Hence, net trade contribution to economic growth may gradually improve over the medium term.

C. Sectoral Output

On the production side of the national accounts, the performance of various sectors mirrored developments in overseas demand. The industrial sector, particularly its manufacturing component, was the key driver of economic growth during the years with a benign external environment. Indeed, industrial output grew by about 8% per annum over 2006-1H 2008 and 9.4% per annum over 2010-11, led by export-oriented metallurgy, machine building and chemicals. At the same time, these industries were also the main source of external weakness in the Ukrainian economy. Thus, industrial production was down by 1.8% yoy in 2012 as output in metallurgy, dragged down by weaker exports, declined by over 5% yoy, while less friendly trade relations with Russia caused a 6% yoy decline in machine building. Wholesale

GDP Growth by Value Added, percentage points



Source: SSS of Ukraine, The Bleyzer Foundation trade and cargo transportation are among other sectors highly dependent on foreign trade performance. As a result, cargo transportation turnover grew by 4% per annum during 2006-07 and recovered strongly at 6% pa in 2010-11, but declined sharply in the weak foreign trade years of 2008-09 and 2012.

Thanks to strong growth in household disposable income and booming credit, the construction sector was among the fastest growing sectors over 2006-07 (up by about 13% per annum). But after the 2008 financial crisis, the construction sector continued to decline (with the exception of 2011, when large public infrastructure spending spurred a temporary increase in construction activity). The sector has been affected by subdued credit supply as well as the ongoing deleveraging by both the corporate sector and private households.

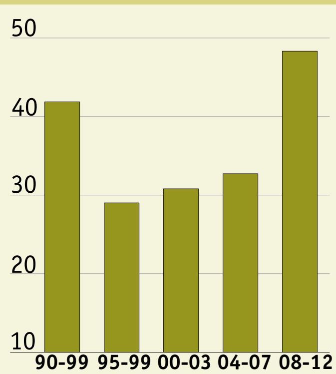
On the other hand, robust growth of domestic demand has helped sustain business activity in local services and, thus, partly offset output losses in the goods-producing sectors of the economy. Indeed, retail sales turnover was up by 13.5% per annum over 2010-12. Other market services, such as education and healthcare, also remained fundamentally strong. But the performance of the financial service sector after the financial crisis differed substantially from its pre-crisis development. Financial services grew by almost 15% pa in 2006-07, stimulated by aggressive strategies of foreign banks and non-bank financial institutions, whose presence notably increased during these years. Credit expansion, however, was not accompanied by adequate regulatory supervision, while lending standards remained relaxed. As a result, the global financial crisis and economic downturn adversely affected the banking system in Ukraine by reducing their access to foreign capital. On the domestic side, Ukrainian banks faced higher credit and liquidity risks as non-performing loans surged. Turbulent international financial markets and a worsening economic environment for foreign parent banks in their home markets made foreign debt rollover by the Ukrainian banks very challenging. Many western banks revised their market strategies for Ukraine and some of them left the country. While this process was softened by higher expansion of Russian and domestic-owned banks, the value of financial services fell by about 7% per annum in real terms on average over 2008-12.

Agriculture has had a significant impact on real GDP growth. Grain production in Ukraine has increased significantly over the last ten years, from 29 million tons in 1995-99, to 31million tons, in 2000-03, to 35 million tons in 2004-07, and to 48 million tons in 2008-12.

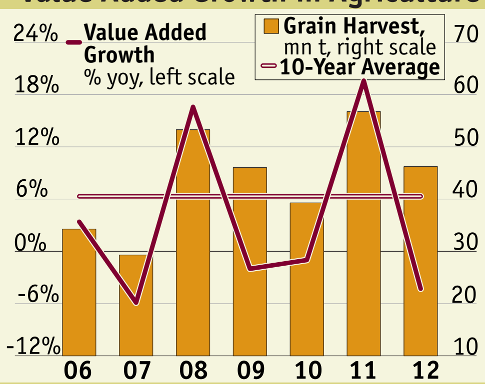
Its impact, however, tends to fluctuate significantly as sector performance is mainly driven by weather conditions. Although in 2012 the agricultural sector produced an output higher than the average for the preceding five years, it was below the record level experienced in 2011. Therefore, the sector showed negative growth of about 5% in 2012. At the same time, abundant crop production over the last few years underpinned solid development in animal breeding. As a result, agricultural output expanded by a strong 5.8% yoy in 1Q 2013. In addition, thanks to improved agricultural production in recent years, the sector's share in GDP reversed its downward trend, rising to an average of 8% of GDP in 2010-12 from less than 7% over 2007-09.

Despite recent increases in agricultural output production, Ukraine still has enormous future potential for improvement due to its fertile soil and favorable climate. In fact, average crop yields in Ukraine remain significantly lower than in Western Europe. With adequate investments in agricultural machinery, fertilizers, seeds, and managing practices, and with favorable government policies, Ukraine may become the world's 3rd largest producer with an output of 130-150 million tons of grains and the world's leading

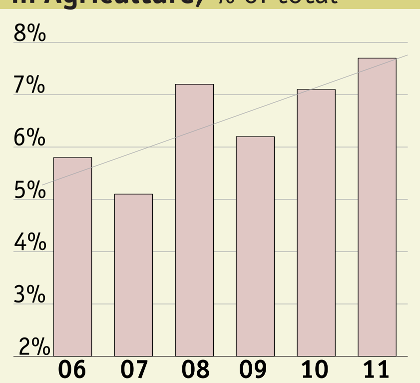
Grain Harvest in Ukraine, million tons



Impact of Grain Harvest on Value Added Growth in Agriculture



Investment into Fixed Capital in Agriculture, % of total



Source: SSS of Ukraine, The Bleyzer Foundation exporter of wheat and coarse grains (corn and barley), with exports of 110-130 million tons. Agriculture could become the main driver of economic growth in Ukraine.

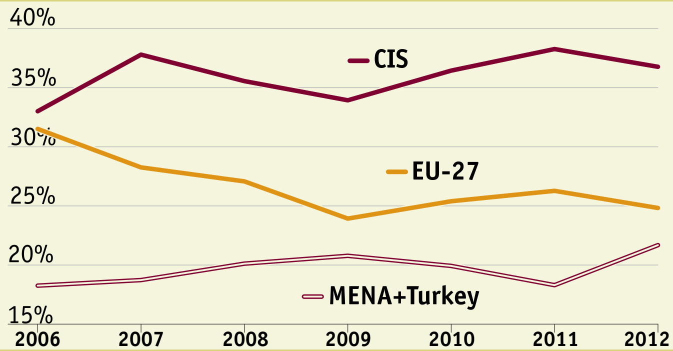
GDP Growth Prospects

Over the medium-term, Ukraine should be able to grow by 4%-5% per annum. However, in 2013, weak external demand, affected by economic weaknesses in the Eurozone, will weigh on economic growth of the Ukrainian economy this year. Real GDP is forecast to increase by about 1% yoy in 2013 and pick up to 3%-4% yoy the next year.

The positive momentum in private consumption is forecast to support economic growth in the next couple of years. Consumer spending will be sustained by diminished inflation expectations and a more stable exchange rate. Although budget spending is forecast to grow at a more reserved pace, fiscal consolidation is likely to be achieved at the expense of public investment rather than expenditures on the public wage bill, social welfare and protection. Hence, anticipated fiscal tightening is likely to have a moderate impact on private consumption growth but will exert a toll on government consumption and investment.

Although buoyant household consumption will support imports, their increase may be contained by government efforts to reduce the volume of energy imports, diversify energy supplies and stimulate domestic extraction of energy resources. By entering into agreements with several multinational oil companies to develop shale gas deposits, Ukraine will reduce its dependency on energy imports, while an increase in the extractive industry and associated FDI will support domestic economic growth.

Merchandise Export Structure by Select Region, % of total



Source: SSS of Ukraine, NBU, The Bleyzer Foundation

In addition, a gradual strengthening of the external environment of Ukraine's main trading partners should support Ukraine's exports in the future. Furthermore, over the medium-term, exports will benefit from improvements in agricultural production, greater export diversification towards high-growth emerging markets (see chart above) and entering a Free Trade Agreement with the EU.

Moreover, as noted earlier, Ukraine has the highest potential to increase grain production and exports over the next ten years, according to OECD-FAO projections for 2021. Recent increased domestic and foreign investments in the sector as well as rising grain production (the average grain output production over 2008-12 was almost 50% higher than the average output over the preceding five years) may signal that the country is gradually unlocking this potential.

Ukraine completed negotiations on a Deep and Comprehensive Free Trade Agreement with the EU in 2012, but the initialling of the agreement was kept in abeyance by the EU, principally due to concerns with political matters. Nevertheless, this FTA and EU cooperation agreement should be initialled in late 2013. Although the elimination of tariffs and other quantitative restrictions would have only modest economic benefits for Ukraine, closer cooperation with the EU will support institutional development in Ukraine and will encourage implementation of economic reforms and improvement in the business climate. Moreover, being in the supply chain for the large European market, Ukraine would attract large foreign direct investments. As a result, an initial negative contribution of net exports is forecast to gradually subside over the medium-term.

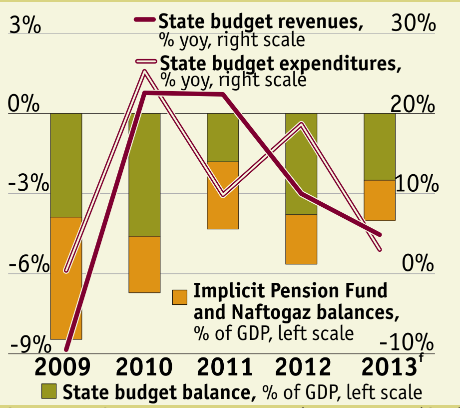
Over the longer term, Ukraine may achieve and sustain even higher GDP growth rates of 5%-7% pa. Indeed, amid a large consumer market with a population over 45 million, an educated and relatively cheap labor force, fertile land and a favorable climate, one of the largest potential amounts of shale gas in central and Eastern Europe, and a favorable geographic location at the cross roads of trade flows to Asia and the EU, Ukraine has a good potential to become the growth leader in the region again if it proceeds with business and investment climate improvements.

D. Fiscal Developments

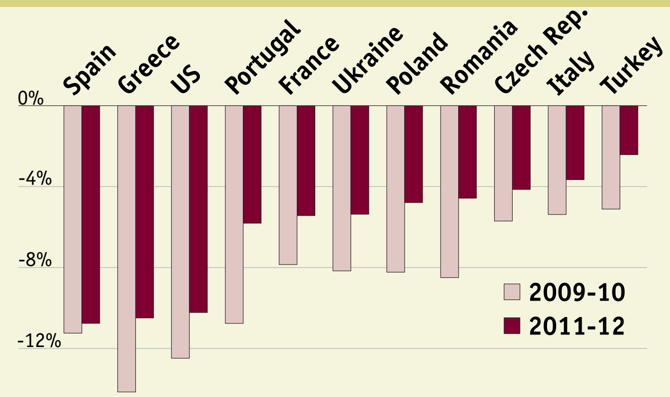
Ukraine's fiscal policy was mostly expansionary over the last decade, fuelling domestic demand. State budget expenditures grew by about 33% per annum over 2003-08 amid increases in public wages, pension benefits and partial repayment of depreciated Soviet era deposits. At the same time, the deficits remained moderate at below 2% of GDP on average over the period, thanks to significant increases in budget revenues that originated from the elimination of a number of privileges and exemptions, improvements in tax administration and robust economic activities.

The economic downturn following the global financial crisis of 2008 weighed on budget revenue growth, causing a widening in fiscal imbalances (including Naftogaz and Pension Fund deficits) to 8.5% of GDP in 2009. At the same time, thanks to implementation of fiscal adjustment measures and solid recovery of the Ukrainian economy, the deficit was reduced to 4.3% of GDP by 2011. Although fiscal consolidation was slower than anticipated by the IMF program, the fiscal situation in Ukraine is compares favorably to other countries in the region.

Ukraine's General Fiscal Deficit, % of GDP



General Public Sector Balance in Select Countries, % of GDP

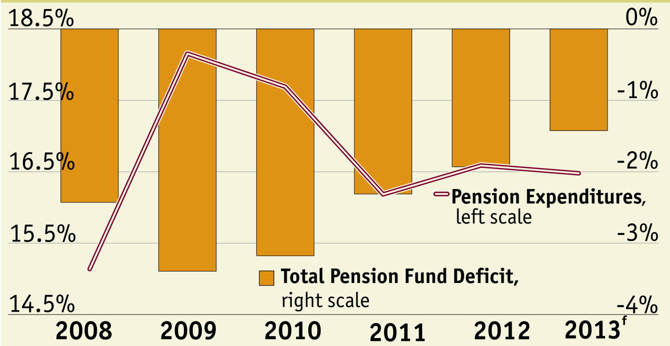


Source: EC European Economic Forecast (Spring 2013), Ministry of Finance of Ukraine, The Bleyzer Foundation

The reduction in the fiscal deficit was achieved thanks to fiscal consolidation measures on both revenue and expenditure sides. In particular, the Ukrainian authorities increased excise rates, reformed the simplified taxation system to reduce tax evasion, reduced subsidies and expenditures on public administration, and improved tax administration.

In addition, the government raised natural gas prices to population and households by 50% in August 2010 and another 15% in January 2011, in order to reduce the burden of high Naftogaz imbalances on the state budget, which stemmed from heavily subsidized household gas and heating tariffs. While natural gas prices for industrial producers were adjusted to market rates, utility tariffs for the population were much below the price for imported natural gas (at around 30%, according to various estimates).

Ukraine's Pension Fund Performance, % of GDP



Source: Pension Fund of Ukraine, Accounting Chamber of Ukraine, The Bleyzer Foundation

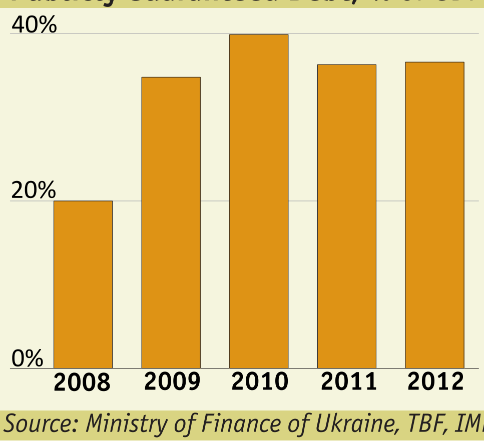
Furthermore, the government initiated highly unpopular pension reform in 2011. The pension age for women was increased from 55 years to 60 years, on par with men's retirement age, rising gradually by six months per year during the next ten years. The minimum number of years people pay pension contributions to be eligible for minimum pension benefits was increased by 10 years to 30 years for women and 35 years for men. The pension reform law also set a maximum cap on pension benefits for new pensioners. Although further reform efforts are required (Ukraine has very generous eligibility criteria for early pension benefits) and the full-scale impact of these measures may be expected in the medium-term, the approved measures helped reduce Ukraine's pension spending from 18% of GDP in 2009 to 16.4% of GDP in 2011-12 and narrowed Pension Fund deficit from nearly 3.5% of GDP in 2009 to 1.9% of GDP in 2012.

Due to the economic slowdown, the fiscal budget deficit widened somewhat to 5.6% of GDP (including the deficits of the Pension Fund and Naftogaz) in 2012 as budget revenue growth was much weaker than the original budget estimate. Moreover, following a number of unpopular measures, the government refrained from further adjustment in natural gas tariffs to the population. Consequently, Naftogaz required government support to cover its deficit, estimated at about 1.8% of GDP in 2012. The Ukrainian authorities hope that the reduction in volumes of gas imports and diversification of imported energy import supplies, efforts to modernize its gas transportation system and restructure Naftogaz, and good prospects for increasing domestic supply of energy resources (thanks to exploration of shale gas deposits) will help sustain Naftogaz finances without the painful tariff increases or with their very gradual adjustment.

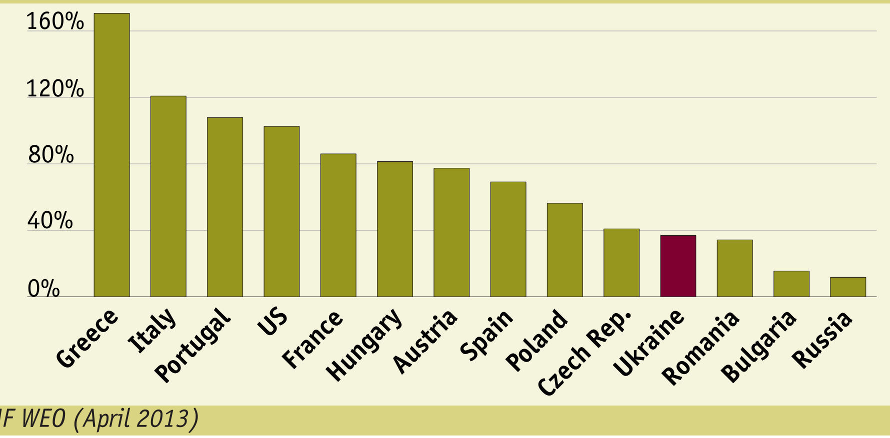
Given that Ukraine continues negotiations with the IMF on a new loan and the Fund insists on tougher fiscal austerity measures to sustain public finances, fiscal consolidation progress is expected to be resumed in 2013. The government's fiscal budget deficit is forecast to be reduced to 4% of GDP in 2013 and 3% of GDP next year.

Despite a temporary relaxation in fiscal consolidation in 2012, a major reduction in the fiscal deficit from a 2008 high helped reverse the public debt path on a downward trend since 2010. During 2011-12, Ukraine's public and publicly guaranteed debt stabilized at around 36.6% of GDP. With this level of public debt, Ukraine is compared favorably to other countries in the region.

Ukraine's Total Public and Publicly Guaranteed Debt, % of GDP



General Government Gross Debt in Select Countries in 2011, % of GDP



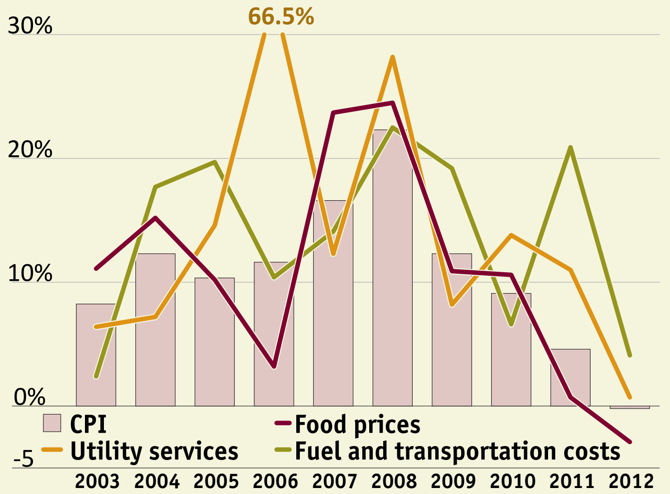
Source: Ministry of Finance of Ukraine, TBF, IMF WEO (April 2013)

E. Inflation and Monetary Conditions

Ukraine has made substantial progress in bringing down inflation from double digits over 2004-09 to single digits in 2010. Moreover, inflation stayed on a downward trend over the next two years and reached -0.2% yoy in 2012, a historically low reading. This favorable inflation outcome was mainly achieved on account of tighter fiscal and monetary policies and declining food price pressures. The prices of food, the heaviest component in the consumer basket, accounting for about 53%, benefited from increases in agricultural harvests over the last five years.

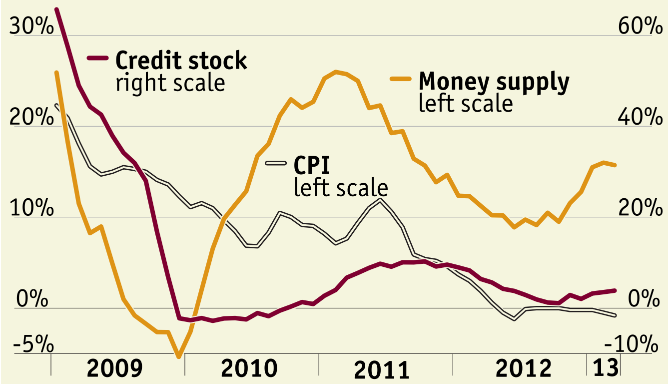
Due to tepid global economic growth and improved energy supplies, the dynamics of world energy prices have stayed mostly subdued since 2008 (with the exception of 2011 when world energy prices were affected by political unrest in a number of MENA countries and the civil war in Libya). As a result, domestic fuel prices have been decelerating, also exerting downward pressure on the cost of public transportation services. In addition, following some adjustment during 2010-11, utility tariffs barely changed in 2012, increasing by only 0.7% yoy over the period. The government has been actively seeking ways to sustain Naftogaz financing without a painful adjustment to the natural gas tariff for the population. Although they are likely to be raised eventually, the increase may be relatively gradual or may apply to only select households.[1] Thanks to improving food supplies and moderate tariff adjustment, inflation is forecast to remain in low single digits in both 2013 and 2014.

Evolution of Consumer Price Inflation,
end of period, % yoy



Source: SSS of Ukraine, The Bleyzer Foundation

Money and Credit Growth in Ukraine, % yoy



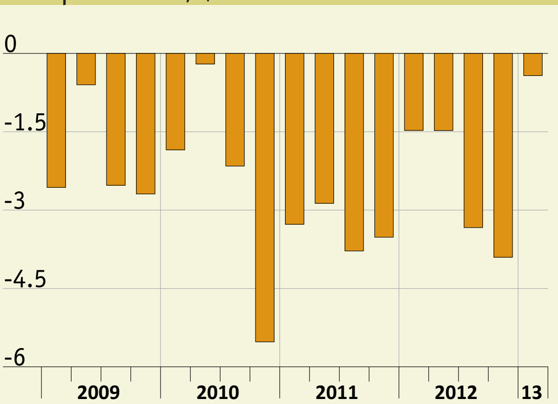
Source: NBU, TBF

In addition, lower fiscal deficits and tight monetary policy will also contribute to relative price stability in Ukraine. In fact, the monetary sources of inflation appear to have been well contained since 2008. The growth in money supply moderated to around 11% pa on average in 2009-12 compared to over 40% pa before the 2008 crisis. Although the monetary authorities possess the whole range of monetary instruments to affect the development of monetary aggregates, their dynamics are largely determined by the stance of the foreign exchange market. This stems from the fact that Ukraine has been de facto operating under a pegged exchange rate regime. Although both price and national currency stability are among the official targets for the NBU policy, in practice the latter has a clear priority. As a result, money supply stayed tight in the aftermath of the crisis amid NBU efforts to contain Hryvnia depreciation pressures. Indeed, after a sharp nominal adjustment in the Hryvnia exchange rate with respect to the US Dollar at the end of 2008, the exchange rate was kept relatively stable at around UAH 8.0 per USD.

Tighter money supply, however, led to a rise in interest rates and undermined credit growth. The stock of bank loans to the private sector expanded by a modest 4.2% per annum over 2010-12, which contrasted

Purchasing Power Parity Estimates for Ukraine
price level in Ukraine vis-a-vis the main trading partners

Population Demand for Foreign Currency,
net purchases, $ billion



Source: IMF WEO (April 2013), NBU, The Bleyzer Foundation

[1]At the beginning of 2013, the Ukrainian authorities signaled that the government may increase natural gas tariffs for wealthy households.

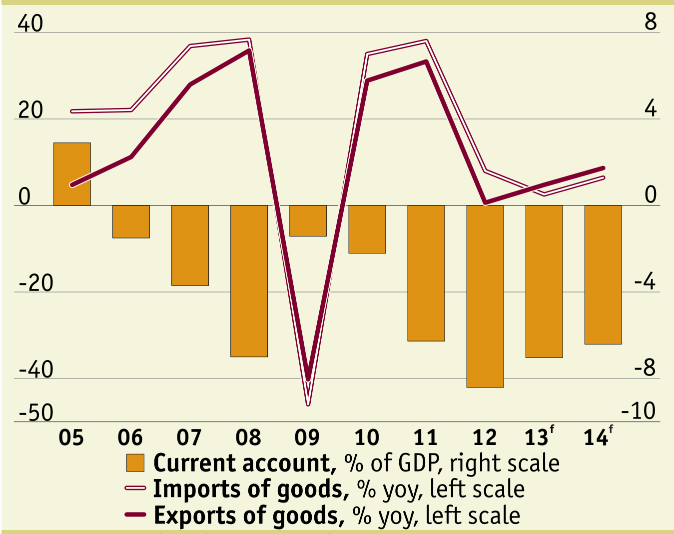
sharply with over 70% pa growth during 2006-08. At the same time, purchasing power parity estimates for Ukraine point to diminished Hryvnia depreciation pressures. Indeed, due to subdued price growth since 2010, inflation in Ukraine was and is forecast to stay lower than in its main trading partners, indicating that the country has restored its international competitiveness lost during the high inflation pre-crisis years. In addition, population demand for foreign currency has calmed amid an improved macroeconomic environment and strengthening consumer confidence. Indeed, over 2008-2012, large foreign currency purchases by the population were a significant drag on both the capital account of Ukraine's Balance of Payments and the Hryvnia exchange rate. Since the end of 2012, population demand for foreign exchange declined significantly as net purchases stood at only $0.3 billion in 1Q 2013, compared to a quarterly average of $3 billion over 2010-11. As a result of diminished exchange rate pressures, the National Bank of Ukraine has been loosening the monetary conditions since the end of 2012. The looser monetary stance is forecast to be gradually transmitted into the recovery of bank lending activity

F. Balance of Payments and Exchange Rate

Following a current account rebalancing in the aftermath of the 2008 crisis, Ukraine experienced a steady rise in external imbalances over 2010-12. This recent rise in current account deficits, however, has both common and different sources compared to the previous period. Thus, slowing global economic activity and downward adjustment of world steel commodity prices were the major obstacles to Ukrainian exporters. At the same time, due to a declining share of iron and steel products in total exports, a gradual reorientation of export flows away from recession-struggling European economies and towards high-growth emerging markets, and growing exports of agricultural commodities helped avoid a sizable deterioration in Ukrainian exports like that experienced four years ago.

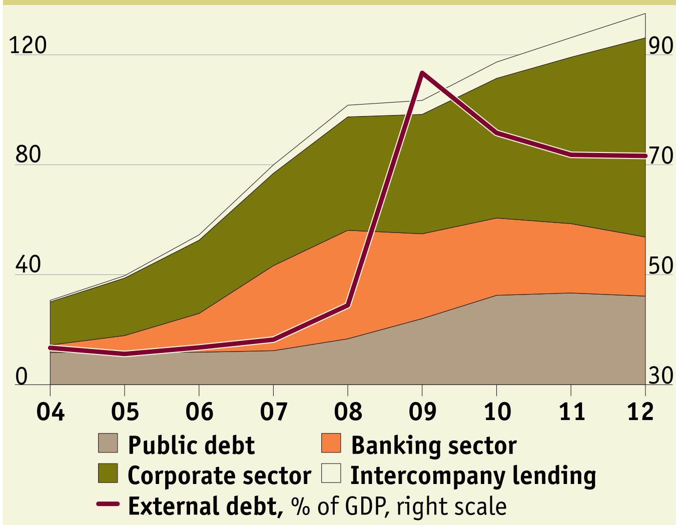
On the import side, the fast growth in energy imports was the principal driver of the widening current account deficit in 2010-2012. Buoyant domestic consumption also contributed, but to a lesser extent than in the past. In fact, natural gas imports from Russia alone account for over 9% of GDP. This high figure stems from the 2009 gas contract with Russia, which requires Ukraine to import Russian natural gas at a price exceeding the spot gas price on the European and US markets. As this source of worsening current account balance cannot be adjusted via currency depreciation, the authorities have been taking steps to reduce the dependency of the Ukrainian economy on imported Russian energy and to stimulate

Evolution of Current Account Balance of Ukraine



Source: NBU, The Bleyzer Foundation

Ukraine's Gross External Debt by Sector, $ billion



Source: NBU, The Bleyzer Foundation

exports. As a result of these efforts, the current account deficit is forecast to gradually narrow over the medium-term.

Unlike in 2008-09, however, Ukraine is currently experiencing solid foreign capital inflows. Indeed, the country generated a $3.6 billion capital account surplus in 1Q 2013, more than twice as much as in the respective period last year. Benefiting from loose international liquidity and a recovery of foreign investors' risk appetite for emerging markets, Ukraine has made several successful sovereign and private Eurobond placements. Solid capital inflows are likely to be sustained in the future by prospects of IMF loan extension and the signature of a Free Trade Agreement with the EU.

Improving foreign capital flows should allow Ukraine to cover its current account deficit and meet its still high external debt financing needs. Indeed, while the banking sector kept going through the process of external debt deleveraging, private corporations were able to maintain high external debt rollover ratios. As a result, Ukraine's gross external debt continued to grow and reached $135 billion at the end of 2012. On a positive note, the ratio of gross external debt to GDP has notably improved, declining from almost 90% of GDP in 2009 to around 73% of GDP in 2012.

The anticipated improvement in Ukraine's Balance of Payments and favorable PPP estimates point to diminished Hryvnia foreign exchange pressures. Exchange rate depreciation may not be an effective adjustment mechanism to reduce external imbalances amid imported energy contract rigidities. On the contrary, Hryvnia depreciation will increase the energy import bill burden on the current account and the fiscal budget, as well as enlarge the cost of external debt servicing.

As a result, we believe the National Bank of Ukraine will continue targeting Hryvnia exchange rate stability with a maximum devaluation of about 5% over the next few years, to a level of around 8.4-8.5 UAH/USD.

G. Economic Reforms since Independence

Since the breakup of the Soviet Union, Ukraine has made progress over the last 20 years in improving its business environment and in creating a free and competitive market. In fact, today, Ukraine can show many areas of progress:

(i) its 1996 constitution guarantees private property and marketbased principles for the country's economy;

(ii) it is now a member of the World Trade Organization;

(iii) it has been recognized by the US and Europe as a functioning market economy;

(iv) it has a largely free international trade system;

(v) most domestic prices are unregulated – except for some food items;

(vi) except for a handful of "strategic" public enterprises in energy and large infrastructure, most public companies have already been privatized;

(vii) about one-third of the banking sector is now foreignowned;

(viii) a new Tax Code has been enacted that reduced the total number of taxes, will reduce the corporate tax rate from 25% to 16% by 2014 and will reduce the VAT rate from 20% to 17% in 2014;

(ix) a new Customs Code has been enacted to make customs procedures more in line with European standards;

(x) it has made some progress in business deregulation by eliminating a number of licenses, reducing the number of inspections, and simplifying procedures for starting new businesses; and

(xi) it has initiated and formally finalized negotiations with the EU on an Association Agreement including a Free Trade Agreement. As a result of these policy changes, since the breakup of its planned economy, the Ukrainian private sector has developed to that extent that it now generates over twothirds of GDP. GDP per capita in US Dollar terms has increased from less than $500 in 1992 (after Ukraine gained its independence) to a current level of $3,600 (according to IMF estimates). Improvements in the country's business climate allowed it to attract significant amounts of Foreign Direct Investments, which reached a record total stock of $50 billion at the beginning of 2012.

Despite the progress made in Ukraine's investment climate, additional policy reforms are needed to create a more transparent, predictable, and level playing field for all enterprises. The Bleyzer Foundation, along with international organizations and other NGOs, have identified many of the policies areas where reform is needed. In particular, there is a need to improve the workings of the legal system to make the Judiciary more effective, transparent and accountable; further deregulate business activities by reducing the number permits needed for registering property, starting a business, carrying out construction activities, and securing utility provision; eliminate threats to property rights; facilitate the paying of taxes and reduce inconsistencies in the administration of taxes; improve the efficiency of public administration; deal with corruption; and improve the country's international image.

The Bleyzer Foundation (TBF) has been playing an important role in helping Ukraine improve its business climate and attract larger amounts of investments. The Bleyzer Foundation is an international economic policyoriented think tank that started its activity in Ukraine in 2001. Since then, it has published a number of documents related to policy measures required to improve the business environment. It has worked with the USUkraine Business Council, the Grain Association of Ukraine and other NGOs to identify measures to remove constraints to investments. It actively cooperates with the Presidential administration, the Cabinet of Ministries, the Ministry of Economic Development and Trade, the Ministry of Finance, the National Bank, and number of other government and nongovernment institutions in formulating effective economic policies. TBF is currently involved in a number of new economic initiatives in the country. TBF activities include: (i) organizing public discussions such as conferences and round tables on the most important topics of the future of Ukraine; (ii) participating in government and nongovernment working groups and other initiatives on matters related to the country's business environment; (iii) active cooperation with the USUkraine Business Council, AmCham, European Business Association, and other business-oriented associations on matters related to improvements in the business environment; and (iv) publications in Ukrainian and international media.

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