Ukraine
Macroeconomic Situation

June 2009

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Summary

- March-April macroeconomic data revealed early signs of stabilization in Ukraine's economic situation. However, the magnitude of the economic downturn means that the economy is still in a difficult situation.
- Although the government is still reporting an over-fulfillment of budget revenues, deeper fiscal data reveals a worrisome picture.
- Being reluctant to revise the 2009 budget, the government has been seeking measures to increase budget revenues and secure sufficient financing for the planned budget deficit.
- In mid-May, the IMF Board agreed to relax fiscal budget requirements for Ukraine to a deficit of 4% of GDP. Moreover, according to the revised program, a portion of the IMF funds will be used to cover the fiscal gap.
- Inflationary pressures continued to ease; the annual consumer-price index (CPI) declined below 15% in May.
- Following sharp depreciation in the fall of 2008 and high volatility in the first three months of the year, the Ukrainian Hryvnia stabilized during April and gained 5.3% in May.
- While regular NBU interventions and administrative controls have contributed to the stabilization of the forex market, we believe that the rapid adjustment of the current account and improved sentiments over Ukraine's ability to serve its large short term debt obligations in the near term were the most crucial.

Economic Growth

March-April 2009 data showed that the pace of economic decline in a number of sectors (e.g., industrial production, construction, and passenger transportation) has slowed. Inflation has notably decelerated, the national currency has stabilized and even started to appreciate during April-May, and the current account gap narrowed dramatically in 1Q 2009. The recent risk-appetite reversal on global financial markets and the resumption of the IMF stand-by program to Ukraine were reflected in the sharp decline of CDS spreads for Ukraine (from more than 5000 basis points to less than 1800 points at the end of May) and revival of the Ukrainian stock market. By the end of May, the PFTS stock market index had gained 120% since March's bottom, although this growth was achieved on relatively low trading volumes and on a very low base.

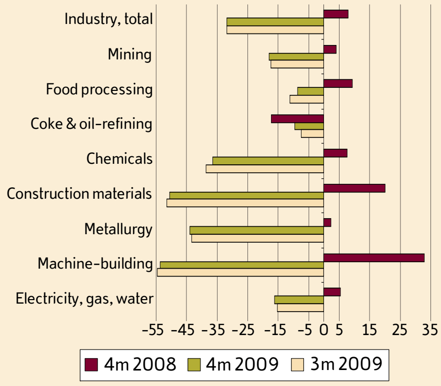
Ukraine's Real Sector Performance, % yoy 1

	Jan-Apr 2009	Jan-Apr 2008	2008
Agricultural output	2.1	0.1	17.1
Industrial output	-31.9	8.0	-3.1
Construction works	-55.6	0.0	-15.8
Wholesale trade	-28.5	8.7	-6.0
Retail trade	-14.3	29.0	18.6
Cargo transportation	-38.4	6.7	-0.2
Passengers transportation	-9.7	4.7	4.5

Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Although this news might create the feeling that Ukraine has already reached the bottom, the severity of the economic downturn over the first four months of 2009 does not provide much comfort. In particular, industrial production fell by almost 32% yoy over January-April 2009. According to various estimates, real GDP shrunk by more than 20% yoy in 1Q 2009. The magnitude of the downturn compared to the worst years of economic depression during the early 1990s, which was caused by a difficult transformation from planned to market economy. The disproportionately high impact on Ukraine may be attributed to slow and piece-meal reforms, the lack of a broad-based and comprehensive program to diversify, modernize and to make the Ukrainian economy more efficient and thus more competitive on international markets. Such a sharp contraction may be one of the main reasons why Ukrainian authorities have decided to delay the release of the first quarter national accounts data for the beginning of July 2009.

Industrial Output by Selected Branches, % yoy 2



Source: State Statistics Committee of Ukraine

With the previous economic growth heavily hinged on external demand, Ukraine's export-oriented sectors continued to suffer from the sharp decline in commodity prices and economic woes in the Ukraine's main trading partner countries. Thus, production in metallurgy, the chemical industry and machine-building fell by 44% yoy, 36% yoy and 54% yoy respectively over the first four months of 2009. At the same time, the impact of the crisis on domestic demand has strengthened since the beginning of the year. Retail trade turnover and the value of passenger transportation works declined by more than 14% yoy and 10% yoy respectively over January-April. Food processing production fell by almost 9% yoy over the period.

Meanwhile, the output decline in many domestic-market-oriented industries and sectors slowed during March-April, which may be explained by two major reasons. First, during almost a decade of fast economic growth, Ukrainian households saved enough to mitigate the crisis' impact for a few months. Moreover, farming, which employs about one-fifth of the total workforce, continued to expand. Actually, agriculture was the only sector that demonstrated an increase in output, growing by 2.1% yoy over January-April. Second, sharp Hryvnia depreciation at the end of 2008 gave new impetus to import-substituting industries. At the same time, this competitiveness gain is hampered by banking sector weaknesses, depriving the economy of credit resources. The credit dry-out and weak demand have already resulted in a 40% yoy decline in investments in fixed assets. However, assuming a gradual recovery of world commodity and financial markets in the second half of the year, a successful bank recapitalization program and prudent fiscal policy despite the coming presidential election, we project the economy to contract by 8% yoy in 2009.

Fiscal Policy

A steep decline in economic activity over the first four months of the year should have caused a notable deterioration in budget revenues. However, the government is still report-

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ing above-target proceeds to state coffers. In particular, the government reported that the general fund of the state budget was over-fulfilled by 1.3% and 5.7% in March and April respectively. Moreover, in April, proceeds to the special fund of the state budget were almost 34% above the planned amount. As a result, according to the Minister of Finance, total consolidated budget revenues amounted to UAH 65.7 billion in 1Q 2009 and were 6.5% yoy higher in nominal terms. Thanks to tight control over expenditures, the consolidate budget was reported with a small deficit of UAH 74 million ($9.5 million) in the first quarter of the year.

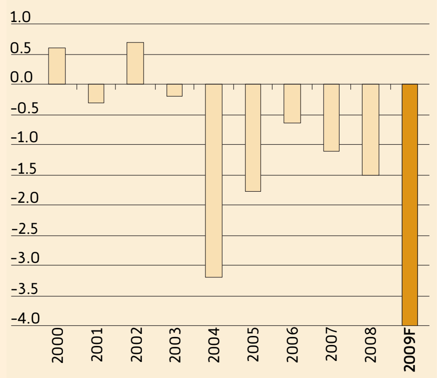
Information on both budget revenues and expenditures is quite scarce and often contradictory. The government releases budget execution data with a several month lag. Moreover, it appears that any other source of budget sector information but the Ministry of Finance is suppressed. Thus, since early April, the State Treasury has stopped publishing the cash balance on the unified state treasury account, which was usually used to assess current budget performance. Budget reviews, regularly published in the analytical reports of the Ministry of Economy and other government institutions, were eliminated. The revenue targets announced at the beginning of the year and those actually reported suggests that the plans have been corrected downwards, although the new targets were not announced. According to the presidential secretariat, proceeds collected to the general fund of the state budget were 0.3% lower than the target for the first four months of the year, while the government reported an almost 4% over-execution.

The sustainability of the state budget revenues raises serious concerns as the government has relied heavily on one-off revenues and early payments of tax bills and other charges. According to the presidential secretariat, early payments to the budget grew from less than UAH 4 billion ($0.5 billion) at the beginning of the year to almost UAH 12 billion ($1.6 billion) at the beginning of May 2009. Moreover, during April the NBU transferred UAH 3.4 billion as the positive difference between the NBU's revenues and expenditures in 2008. According to the 2009 Budget Law, these funds were planned to be received in equal installments of about UAH 1 billion on a quarterly basis. However, the annual target for the NBU payments was already met in April. Excluding the NBU advance payments, revenues to the general fund of the state budget turned out to be under-fulfilled by 12% in April. Even excluding other advance tax payments and one-off transactions (e.g., VAT proceeds from the customs clearance of 11 billion m^3 of natural gas imported last year by RosUkrEnergo), this estimate indicates that state finances are indeed under significant strain.

Despite worrisome developments, the government is very reluctant to revise the 2009 budget. The revision would likely mean a necessity to revise downwards government expenditures on public wages and social transfers. At the same time, such a move looks quite problematic for the government ahead of the upcoming presidential election. Alternatively, the government has been seeking measures to increase budget revenues and secure sufficient financing for the planned budget deficit. In particular, in mid-April, the government raised a number of excises (on alcohol, tobacco, etc.), confined maximum pensions, increased deductions to the Pension Fund of Ukraine for entrepreneurs who chose a simplified taxation system, etc. Observing these measures, the IMF resumed its financing to Ukraine under the stand-by program at the end of April. Moreover, the IMF relaxed its original fiscal deficit requirements for Ukraine from a balanced budget to a deficit of UAH 40 billion (about $5.2 billion), or 4% of GDP (excluding expenditures on bank recapitalization). This larger deficit was accepted considering the relatively small public debt ratio and the past record of low deficits. Moreover, the IMF agreed to direct $1.5 billion (1.2% of GDP) from the second tranche to finance the fiscal budget deficit in 2009. The latter reflects the shift in the government approach towards external financing of the targeted budget deficit this year.

Initially, the targeted fiscal deficit of 3% of GDP was expected to be financed primarily by domestic financial sources. According to the 2009 state budget law, funds from issuance of domestic debt securities, privatization proceeds and accumulated cash balances on the unified treasury account should have been sufficient to cover almost 80% of the budget gap. The 20% remaining was planned to be raised from external markets. But given the sluggish privatization process and weak domestic borrowing market, now the government plans to raise about 60% of the state budget financing needed from external sources. Ukrainian authorities have been working to secure external financing from a number of international financing institutions (the World Bank, EBRD, etc.) as well as bilateral financing. So far, however, the talks on the latter have not been successful and the government has relied on the issuance of domestic debt securities.

Consolidated Budget Performance 3



Source: Ministry of Finance, The Bleyzer Foundation

At the same time, domestic debt securities saw little demand from the commercial banks due to unattractive premiums and tight liquidity in the banking system. Though the dubious clauses that obliged the central bank to buy-out the government securities from commercial banks in three days upon request were removed from the state budget law in mid-March 2009, the NBU remained the principal buyer of government bonds in April. Over the month, the government bonds portfolio of the NBU grew by 31% to UAH 23.9 billion ($3.1 billion) at the end of April. At the end of April, the NBU held about 65% of total government securities compared to less than one third at the beginning of the year. The NBU financing of government expenditures may not bear inflationary pressures in the short-term. However, with a slow domestic supply response, the deficit monetization may have serious inflationary consequences as the crisis abates.

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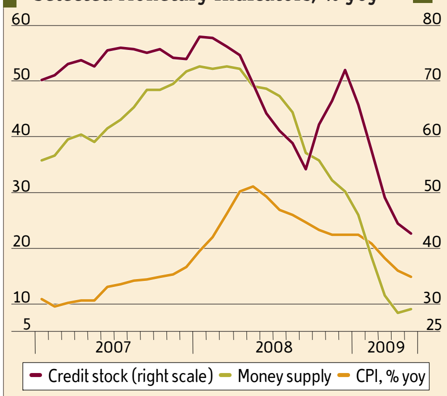
Monetary Policy

Ukraine's consumer price inflation slowed to 0.9% month-over-month (mom) in April and 0.5% mom in May. In annual terms, CPI growth fell to 14.7% in May, down from more than 22% yoy at the beginning of the year and 31% yoy in May 2008. The reduction in inflation is attributed to weaker consumption affected by lower incomes, major reduction in money supply growth and tighter credit. In addition, global recession depressed demand on industrial products and drove down world commodity prices. As a result, Ukraine's domestic producer price inflation decelerated sharply from more than 20% yoy in January 2009 to less than 2% yoy in May 2009. In addition, April-May's CPI developments were favored by a high statistical base effect.

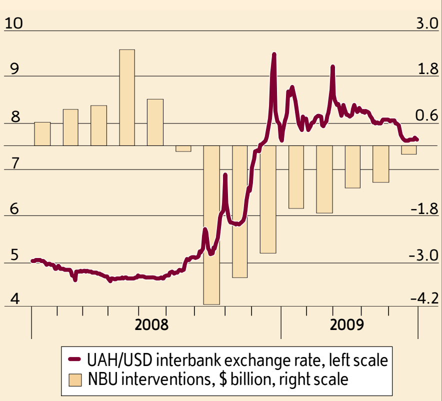
Selected Monetary Indicators, % yoy 4



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

On the back of resumed growth of world crude oil prices, Ukraine's fuel prices also gained 3.7% during April-May. Affected by an increase in excises, prices on alcoholic drinks and tobacco rose by 5.4% during these two months, while the scheduled tariff adjustments drove up the costs of transportation and communication services by 1.9% and 2.3% respectively. The upward pressure on total CPI from the price growth on these commodities and services was partially compensated for by declining food prices, which account for more than half of the consumer basket. Thus, during May, monthly food price growth fell to 0.3% mom, down from a 1.8% mom increase on average during January-April. In annual terms, food inflation eased to 9.3% in May compared to 23% at the beginning of the year and almost 50% in May last year.

Average UAH/USD interbank exchange rate and NBU interventions 5



Source: NBU, Finance.ua, The Bleyzer Foundation

Stabilization of the foreign exchange market and moderate Hryvnia strengthening with respect to the US Dollar also contributed to disinflation during April-May. In particular, during May 2009 the exchange rate appreciated by 5.3% to UAH 7.63 per US Dollar. Market stabilization occurred thanks to regular NBU interventions, administrative measures and special auctions on foreign currency sales. Since September 2008, net sales of NBU foreign reserves amounted to $16 billion. However, as can be seen from the chart below, the scale of the NBU interventions has notably declined in recent months. Since the end of March, the NBU has initiated special auctions selling foreign currency to households to serve their commercial banks' debt liabilities in foreign currency at a preferential rate. The regular auctions have decreased the population's demand on the retail foreign exchange market.

To a significant extent, stabilization on the forex market should be attributed to a number of administrative restrictions on commercial banks' forex transactions and exchange rate volatility. In particular, the NBU banned forward operations with foreign currency, modified the methodology of calculating the open forex position of commercial banks, excluding credit risk provisions for foreign currency denominated loans, and took other measures that restricted exchange rate flexibility. While these measures helped to stabilize the market, they may increase commercial banks' exposure to exchange rate risk and worsen the already difficult financial situation of commercial banks. According to the revised IMF program, the monetary authorities have committed to remove the majority of the exchange rate restrictions. Moreover, at the beginning of June, some of them had already been relaxed (in particular, alleviated requirements regarding an open forex position).

Weaknesses in the banking sector are the major risk for the country at the moment. Rapid growth of domestic credit in the previous years came at the expense of the quality of bank assets. There is growing evidence of rising non-performing assets. In particular, the share of doubtful and loss loans (but excluding sub-standard loans) grew from 2.5% at the beginning of 2008 to 6.3% at the end of 1Q 2009. The total share of non-performing loans (sub-standard, doubtful and loss) may reach 25-30% in 2009. The solvency risk coupled with large deposit outflow (about $13 billion during October 2008-March 2009) and high external indebtedness are now the main challenges for the Ukrainian banking system. The increased solvency risks, tighter NBU regulations and restrictions, the flight in deposits and the need to repay both domestic and external liabilities continued to affect the ability of the commercial banks to provide credit to the private sector. Indeed, the stock of commercial banks credit portfolio declined by 3% from January to May 2009.

At the same time, April-May revealed signs of stabilization in the banking system. In particular, in April households ceased to withdraw deposits from the banking system. This trend continued also in May, supported by an increase in legal entities' deposits. As a result, the total stock of bank deposits grew by 0.3% mom in May, for the first time since October 2008.[1]

[1] Actually, the NBU reported an increase in the stock of commercial banks' deposits during November-December 2008. However, the increase was mainly attributed to valuation adjustments due to sharp Hryvnia depreciation at the end of 2008. In May 2009, despite appreciation of the Hryvnia, the stock of foreign currency denominated deposits grew by 0.7% mom.

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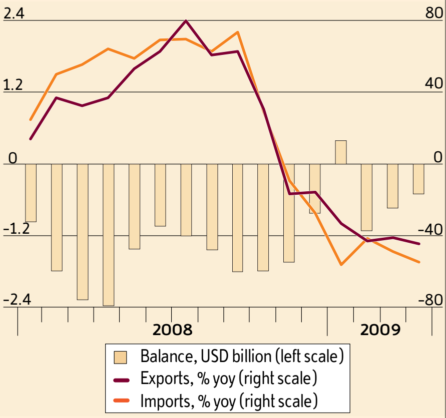
An increase in commercial banks' deposits should be primarily attributed to the stabilization of the foreign exchange market as well as attractive deposit programs developed by the commercial banks. The latter not only raised deposit rates but also proposed flexible withdrawal conditions. At the same time, the restoration of public confidence in the banking system will depend on the success of the bank recapitalization program for troubled banks. Although its implementation was delayed, the government finally approved the recapitalization of the first three banks at the beginning of June. Foreign banks have confirmed their plans to raise $2 billion for the capital of their Ukrainian subsidiaries. Some of the Ukrainian banks have also committed to inject additional capital. If the current recapitalization plans are successful, systemic issues may be under control, though a number of medium and small banks may fail.

International Trade and Capital

Although the above-mentioned causes played a vital role for positive developments on the foreign exchange market during the last few months, we believe that the main reason was that the two main financial vulnerabilities of Ukraine (large current account deficits and large repayments of short term debt) were substantially reduced. First, due to Hryvnia devaluation and weak domestic demand, helped by import restrictions and low world commodity prices, the value of goods imports was more than twice as low over the first four months of 2009 as in the same period last year.

Merchandise Trade Performance, monthly 6



Source: State Statistics Committee of Ukraine,

Imports of transport vehicles, machinery and equipment as well as metallurgical products fell the most, by 82% yoy, 69% yoy, and 62% yoy respectively. Imports of energy resources, the weightiest commodity group in total imports, declined by almost 40% yoy in January-April. A much lower value of energy imports in April compared to March is primarily explained by lower natural gas imports. The later was the product of both a lower price for imported gas in 2Q 2009 ($271 per 1000 m^3 compared to $360 per 1000 m^3 in 1Q 2009) and volumes (due to both contracting real sector activity and postponement of the gas imports to be pumped into gas storage).

Exports continued to suffer from weak demand in the main trading partner countries and low world commodity prices, contracting 41% yoy over January-April. However, due to a more considerable decline in imports, the trade deficit narrowed sharply to less than $2 billion compared to more than $7 billion over the same period last year. Correspondingly, this caused a sharp adjustment of the current account balance. According to preliminary NBU data, the current account deficit constituted $0.6 billion in the first four months of 2009, ten times lower than in January-April 2008. Thus, the current account gap is projected to be reduced from a record high $13 billion (7.2% of GDP) in 2008 to about $3.5 billion (3% of GDP) in 2009.

Second, the resumption of the IMF stand-by agreement for Ukraine along with the likely financing from the World Bank, the EBRD and other financial institutions will reassure foreign creditors that Ukraine should be able to serve its large short term obligations in the near term. According to various estimates, the private sector external debt financing needs may amount to $36 billion in 2009. At the same time, trade credits and liabilities of the Ukrainian subsidiaries of foreign banks represent a substantial portion of the debt obligations due. However, even adjusting for the likely rollover rate, the total external financing gap is estimated at about $10 billion. Although this gap will keep pressure on the balance of payments this year, it looks quite manageable given the level of the NBU international reserves, which stood at $31.5 billion at the beginning of 2009.