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Ukraine Macroeconomic Situation

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- **Victor Yanukovych became the fourth president of Ukraine.**
- **Real GDP fell by 15% in 2009.**
- **The broad fiscal deficit was estimated at 11% of GDP in 2009.**
- **The current account deficit narrowed to 1.7% of GDP in 2009.**
- **Economic performance at the beginning of 2010 is encouraging, although the recovery is forecast to be subdued.**

Executive Summary

Opposition leader Victor Yanukovych won Ukraine's presidential election. During the second round of the election, held on February 7th 2010, Mr. Yanukovych received 48.95% of the vote, overcoming his rival, Prime Minister Yulia Tymoshenko, by about 3.5%. Although the election was declared fair and democratic by all international observers, Ms. Tymoshenko accused the Yanukovych camp of massive vote-rigging in eastern regions of Ukraine and appealed to the Supreme Administrative Court. Later, however, Ms. Tymoshenko called off her lawsuit, accusing the court of being biased against her, and rejected the legitimacy of Mr. Yanukovych's presidency. All in all, Mr. Yanukovych was sworn in on February 25th, 2010 and became the fourth president of Ukraine.

Following the 2005 constitutional reform, which turned Ukraine into a parliamentary-presidential republic, the election of a new president does not lead to the resignation of the government. However, Ms. Tymoshenko continuing service as Prime Minister was unacceptable to the new president. As Ms. Tymoshenko refused to resign, the only two options were reforming the ruling coalition within the current parliament or early parliamentary elections. New elections, however, would mean continuing political instability for another year. Realizing the risks of this option, the party of regions is actively negotiating to form a new coalition. These efforts have already resulted in 243 votes for a motion of no-confidence in Prime Minister Yulia Tymoshenko's government at the beginning of March. This number of votes does not automatically guarantee the successful formation of a new coalition as there is a legislative requirement to have political factions rather than individual deputies as members of the coalition. After the dismissal of the government, there are 30 days to form the new coalition and 60 days to have a new cabinet of ministers. Otherwise, the president will have to call parliamentary elections. We believe that the latter should be avoided thanks to either the respective changes in Ukrainian legislation or as a result of compromises between the Party of Regions, Our Ukraine and Lytyn Bloc.

Regaining political stability is particularly needed in Ukraine, whose economy was hit severely by the international liquidity crisis. In 2009, real GDP fell by 15% yoy, one of the deepest declines in the world. Although the economy started to show signs of improvement in 2Q 2009, the recovery was rather slow. The beginning of 2010 was encouraging as Ukraine's industrial sector reported almost 12% yoy growth on the back of rebounding external demand for Ukraine's exports and a favorable base effect. On the other hand, domestic demand is likely to remain subdued, exerting a toll on economic growth, forecast at a moderate 3% yoy in 2010.

Public finances were under significant strain during 2009. Deep economic recession, banking sector weakness and the forthcoming presidential election resulted in the overall budget deficit surging to 11% of GDP. As current expenditures comprise the lion's share of budget spending and there should be moderate recovery in economic activity, rebalancing public finances should be the main priority and the hardest challenge for Ukrainian authorities in 2010. In the short-term, Ukraine seems to have no alternative but to resume the IMF program.

On a positive note, Ukraine's external imbalances notably declined during 2009. The current account deficit shrank to 1.7% of GDP in 2009 and is forecast to be virtually balanced in 2010. Thanks to IMF and other IFIs financing as well as a high private external debt rollover ratio, external financing needs were successfully met in 2009. Although external debt financing requirements remain high in 2010, they are substantially lower than in the previous year. Moreover, with likely restored political stability and a resumed IMF program, the needs look quite manageable. The reduced vulnerabilities of the Ukrainian economy have already changed the outlook for Ukraine's national currency. Stabilized in the fall of 2009 at about UAH 8.0 per US Dollar, the currency may remain stable at this level during 2010, though there are a number of downside risks to this scenario.

	2005	2006	2007	2008	2009*	2010**
GDP growth, % yoy	2.7	7.3	7.9	2.1	-15.0	3.0
GDP per capita, $	1 830	2 300	3 070	3 900	2 525	2 765
Industrial production, % yoy	3.1	6.2	10.2	-3.1	-21.9	
Retail sales, % yoy	22.4	24.8	28.8	18.6	-16.6	
Budget deficit, % GDP	-1.8	-0.7	-1.5†	-2.1†	-10.6††	-6.5‡
Government external debt, % GDP	13.7	11.0	8.7	9.3	19.9	23.0
Inflation, eop	10.3	11.6	16.6	16.6	12.3	13-15
Gross international reserves, $ billion	19.4	22.4	32.5	31.5	26.5	25.0
Current account balance, % GDP	2.9	-1.5	-3.7	-7.0	-1.7	-0.9
Gross external debt, % GDP	45.9	50.6	56.0	56.4	87.1	81.2
Exchange rate, Hryvnia/US Dollar, eop	5.1	5.1	5.1	7.7	8.0	8.0-8.5

*Preliminary data **Projections †Including implicit pension fund deficit

††Including bank recapitalization and Naftogaz capital injection, implicit pension fund deficit and expenditures covered by IMF's special SDR allocation ‡Including Naftogaz deficit

Sources: State Statistics Committee of Ukraine, NBU, Presidential Secretariat, The Bleyzer Foundation

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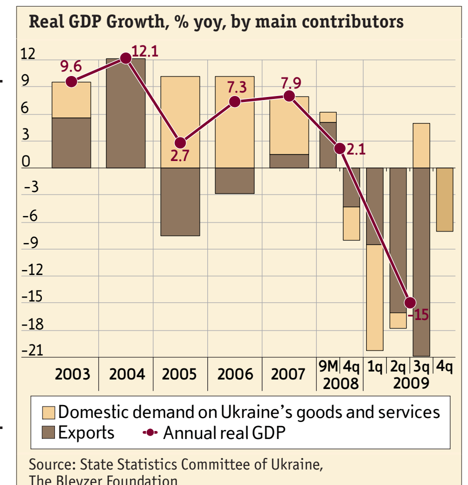
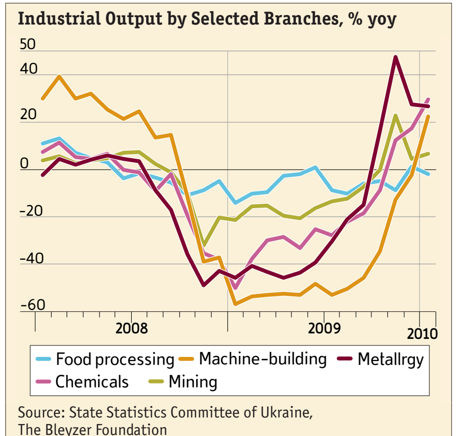
Economic Growth

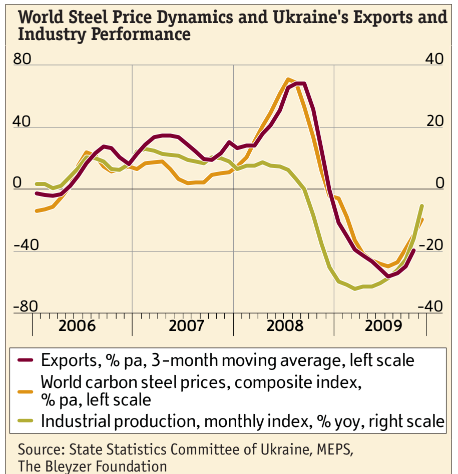
Ukraine has continued to recover from a very deep recession. According to preliminary estimates of the State Statistics Committee of Ukraine, real GDP declined by 7% yoy in 4Q 2009. The economic downturn notably eased in the last quarter of the year (see chart 1) on the back of an improving external environment as well as a low statistical base effect. At the same time, the decline was slightly deeper than expected, which may be explained by the mixed signals of world economic recovery in 4Q 2009 (while the US and Asian economies demonstrated stronger growth, GDP data in the Euro zone was disappointing). The full-year contraction was estimated at 15% yoy in 2009.



Being a very open economy, with exports accounting for about 50% of GDP, Ukraine is forecast to benefit from the expected stronger rebound of external demand in 2010. Real sector data for the first month of 2010 supported the forecast. Industrial production grew by 11.8% yoy in January 2010, driven by export-oriented metallurgy (+26.6% yoy), chemicals (+29.5% yoy) and machinery (+22.3% yoy). The industries benefited from a mix of reviving external demand, improved competitiveness due to sharp Hryvnia depreciation in the fall of 2008 and government stimuli (gas price subsidies to chemical enterprises, preferential cargo transportation tariffs for metallurgical and mining companies, etc.). Favored by a strong rebound in metallurgy, production of iron-ores and coking coal went up by 33.7% yoy and 17.4% yoy respectively. The revival of Ukraine's foreign trade and manufacturing underpinned an almost 16% yoy increase in cargo transportation.



Agriculture, which was virtually the only sector demonstrating small but positive growth in 2009, kept supporting economic activity at the beginning of 2010. Two years of excellent grain harvests gave strong impetus to small livestock raising. Thus, the sector demonstrated 5.4% yoy increase in output in January 2010, though cattle breeding continued to decline.



Despite an encouraging beginning to the year, we adhere to a rather moderate economic growth forecast of about 3% yoy in 2010 principally due to sluggish recovery of domestic demand. The data used to determine the domestic demand trend was disappointing at the end of 2009-beginning of 2010. Thus, retail trade turnover fell by 16.6% yoy in 2009 and was down by an almost 5% yoy in January 2010. Real average wages declined by 9.2% yoy in 2009, though the decline moderated during the last two months of the year. The strained situation with public finances leaves little room for fiscal measures to stimulate domestic demand. Expected double-digit inflation and weak credit activity will also be a drag on households' propensity to consume. Subdued credit activity and still restricted access to foreign financing will weigh on corporate investment. Thus, output growth in the construction sector remained negative, contracting by 24% yoy in January 2010, despite a very strong base effect. The likely continuing political instability during the first half of 2010 may also hamper the pace of recovery.

In addition, although export is likely to be the main driver of economic growth in 2010, its strength may not be sufficient to compensate for domestic demand weaknesses. Ukraine's exports may be hampered by intensified competition on foreign markets amid relatively high dependence on imported raw and energy materials and narrow product and geographic diversification. Furthermore, to a notable extent January's upsurge was attributed to an extremely low statistical base. Indeed, January 2009 was the toughest month in terms of output decline in most sectors. Thus, industrial production fell by 33.8% yoy, with metallurgy, chemicals and machine-building demonstrating the sharpest rates of decline (-45.7% yoy,

-49.8% yoy, -56.8% yoy respectively). Although the impact of the low statistical base effect will be felt throughout all of 2010, it will notably ease through the end of the year. At the same time, the stronger rebound of the world economy, quick stabilization of the political situation and reasonable progress in reforms are among the upside risks to the forecast.

Fiscal Policy

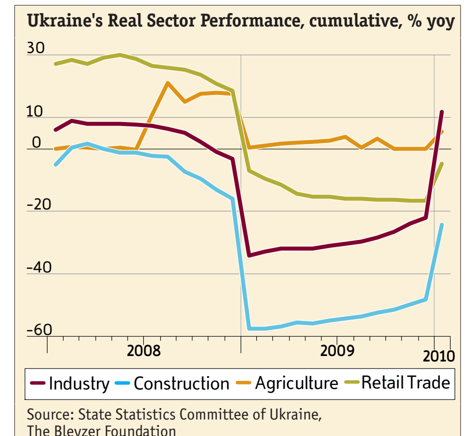
The economic crisis and the presidential election caused Ukraine's fiscal accounts to deteriorate notably in 2009 and put them at risk also in 2010. Officially, Ukraine ended 2009 with a relatively small consolidated budget deficit of UAH 21.6 billion, which is equivalent to 2.3% of estimated 2009 GDP. A relatively small budget deficit was achieved amid a 15% yoy contraction in real GDP and virtually unchanged consolidated budget expenditures. Indeed, consolidated budget expenditures amounted to UAH 307.3 billion in 2009, which was only 0.6% lower in nominal terms than in 2008. Moreover, the decline was achieved mainly on account of a 50% yoy reduction in capital spending, while current expenditures (wages to public sector employees, social transfers, etc.) actually grew by 7% yoy.

Officially, consolidated budget revenues fell by only 3% yoy in nominal terms and stood at UAH 289.5 billion. To some extent, such a relatively small decline in budget revenues was the result of an increase in excises on tobacco and alcohol and an introduction of a 13% temporary import duty mark-up. In addition, the degree of budget revenue deterioration was veiled by advanced collection of taxes and charges to the budget, accumulation of VAT arrears, and extensive reliance on one-off receipts. For instance, the IMF's SDR allocation to Ukraine was counted as budget revenues in November-December 2009. Excluding the SDR allocation from budget revenues, Ukraine posted almost a 4% of GDP deficit.

The overall fiscal deficit, however, was estimated at about 11% of GDP as a number of expenditures were not included in the official statistics. Thus, government spending on bank recapitalization and the Naftogaz capital injection accounted for an additional 5.2% of GDP. Furthermore, Ukraine's Pension Fund looks alarmingly unbalanced. According to Ukrainian legislation, the pension fund deficit is covered by the state budget funds. The 2009 State Budget Law envisaged a Pension Fund deficit at about UAH 14 billion, or 1.5% of GDP. However, the actual deficit turned out to be twice as high. To cover the expenditures, the pension fund received credits from the unified Treasury account, equivalent to about 1.8% of GDP. Increasing pension expenditures, which reached about 18% of GDP in 2009, amid a rapidly aging society became the heavy burden on public finances, urging for radical and comprehensive pension sector reform. Amid a high payroll tax rate in Ukraine, generous early retirement schemes and a retirement age that's one of the lowest in Europe leave sufficient room for re-balancing the pension fund.

Public finances remain under significant strain in 2010, raising concerns about sustainability of public debt and the ability to control inflation. Moderate economic recovery and advance payments of taxes and charges to the budget in 2009 may keep budget revenues at low levels in 2010. At the same time, pre-election hikes in social standards (minimum wages, pensions), delays in tariff increases for natural gas and utilities, accumulated arrears (VAT refund, wages, etc.) suggest bringing public finances to sustainable level may be challenging. Furthermore, facing significant difficulties in budget deficit financing in the second half of 2009, the government actively issued domes-

Ukraine's Real Sector Performance, cumulative, % yoy



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Ukraine's Consolidated Budget Performance

	2008		2009	
	% yoy	% of total	% yoy	% of total
Total Revenues	**35.4**	**100**	**-3.1**	**100**
Total taxes	40.9	76.3	-8.4	72.1
PIT	32.0	15.4	-3.1	15.4
EPT	39.1	16.1	-30.9	11.5
VAT	55.1	30.9	-8.1	29.3
Excise total	21.0	4.3	69.2	7.5
Duties	24.4	4.0	-47.0	2.2
Non-tax revenues	24.6	20.3	22.4	25.7
Total Expenditures	**36.8**	**100**	**-0.6**	**100**
Consumer expenditures	43.1	86.7	7.2	93.5
Capital expenditures	6.5	13.3	-51.5	6.5

Source: Ministry of Finance, The Bleyzer Foundation

Ukraine's Consolidated Budget Performance

Official consolidated budget deficit	2.3
SDR allocation, treated as budget revenues	1.7
Bank recapitalization	2.0
Naftogaz capital injection	3.2
Implicit pension fund deficit*	1.8
Overall budget deficit	11.0

*Credits from unified Treasury account (state budget) to cover pension fund expenditures

Source: Ministry of Finance, NBU, Presidential Secretariat, The Bleyzer Foundation

Ukraine's Public and Publicly Guaranteed Debt, % GDP

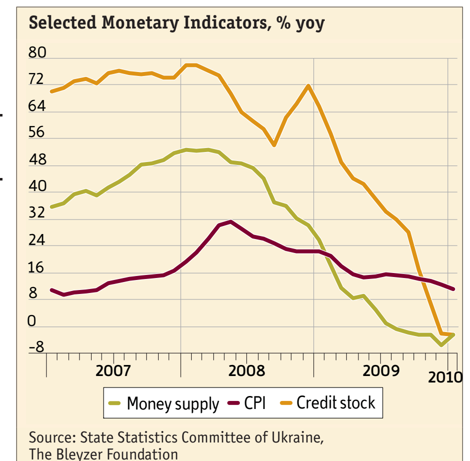
Source: Ministry of Finance, The Bleyzer Foundation

tic debt securities.[1] Sluggish demand, however, resulted in a short-term T-bills rally with yields reaching 25-30%. Although the public debt-to-GDP ratio is still relatively low in Ukraine (about 33% of GDP as of end-2009[2]), increased costs of debt servicing as well as high domestic debt principal payments in 2010 estimated at about UAH 13 billion (1.2% of forecasted GDP) are additional constraints for successful fiscal consolidation in Ukraine.

Obtaining sufficient budget deficit financing is likely to remain a difficult task in 2010. Amid restricted and costly external borrowing resources, expensive domestic funds, the revival of the privatization process could provide a notable part of the required funds. However, in the short term political instability makes this option unfeasible. Hence, over the short-term Ukraine has no alternative but to resume the IMF program and/or secure other multilateral or bilateral financing. Assuming the Ukrainian authorities clearly realize available options and risks related to fiscal deficit monetization, we believe that cooperation with the IMF will be resumed in mid-2010. Bringing back the IMF program will require a number of fiscal austerity measures as well as steps to re-balance Naftogaz and the pension fund. At the same time, some compromise on social expenditures increases may be found. Under these assumptions, the IMF may agree on a 6.5%-7% of GDP deficit for 2010, including Naftogaz imbalances. Although higher than the initially targeted fiscal deficit of 4% of GDP for 2010, it would still represent significant narrowing from the 2009 level.

Monetary Policy

Ukraine's annual consumer inflation eased to 12.3% yoy in 2009, down from 22.3% yoy a year before. The upside inflationary pressures, caused by continuing pass-through of Hryvnia devaluation in the fall of 2008 on consumer goods and higher excises on alcohol and tobacco, were compensated for by good agricultural output for the second year in a raw, a delay in utility tariffs increases, and general deterioration of economic activity. In addition, overall monetary conditions were tight during 2009 despite the NBU refinancing support to commercial banks, some monetization of budget deficit,[3] and an 86% yoy reduction in cash balances on government accounts with the NBU to a meager UAH 1.1 billion at the end of 2009. Regular NBU interventions on the interbank market to support Hryvnia exchange rate ($10.4 billion in 2009), tightening of commercial banks' formation of credit provisions, active use of the NBU deposit certificates as well as sizable placements of domestic T-bills resulted in monetary base growth easing to just 4% yoy in 2009, compared to a 32% yoy increase in 2008. Money supply fell by about 5% yoy in 2009, reflecting the decline in credit activities of the commercial banks.



Indeed, severe deposit runs during October 2008-April 2009 reduced the resource base of the commercial banks. Although the withdrawal of deposits ceased in mid-2009, commercial banks saw rather shallow 3% growth in the stock of deposits in the second half of the year. Overall, the stock of commercial bank deposits fell by 8.4% yoy in 2009. High external indebtedness of commercial banks and a rising share of non-performing loans[4] also undermined credit creation. The total stock of bank loans to the economy of Ukraine declined by only 2% yoy in 2009 compared to an average growth of about 70% over the last five years. Moreover, excluding government-induced loans (i.e., state bank loans to Naftogaz, etc.), the change in credit activity would be even more dramatic. Indeed, an abrupt reduction in credit was one the main reasons for Ukraine's hard lending in 2009.

Monetary sector data for the first month of 2010 demonstrated further weakening of credit activity in the Ukrainian banking sector. Affected by political instability, the stock of deposits fell by 1% month-over-month (mom) in January 2010. Moreover, by placing domestic debt securities for relatively short-term and high yields (though lower than in October-De-

[1] The funds received under the IMF program to Ukraine were one of the main sources of budget deficit financing in the first half of 2009. Indeed, about $4.5 billion out of the $6 billion released by the IMF in 2009 was directed at covering the fiscal financing gap. The IMF program was put off-track in the fall of 2009 as the Ukrainian authorities delayed the natural gas tariffs increases to the population and approved pre-election hikes in social expenditures, in contrast to the IMF requirements.

[2] Public and publicly guaranteed debt.

[3] The program of troubled bank resolution with public funds, capital injections to state banks and Naftogaz Ukraine were financed by the issue of T-bills. The latter was then purchased by the National bank of Ukraine.

[4] According to various estimates, the share of non-performing loans (defined as substandard, doubtful and loss) grew from 14.5% in 2008 to 30% in mid-2009 and about 40% at end of 2009.

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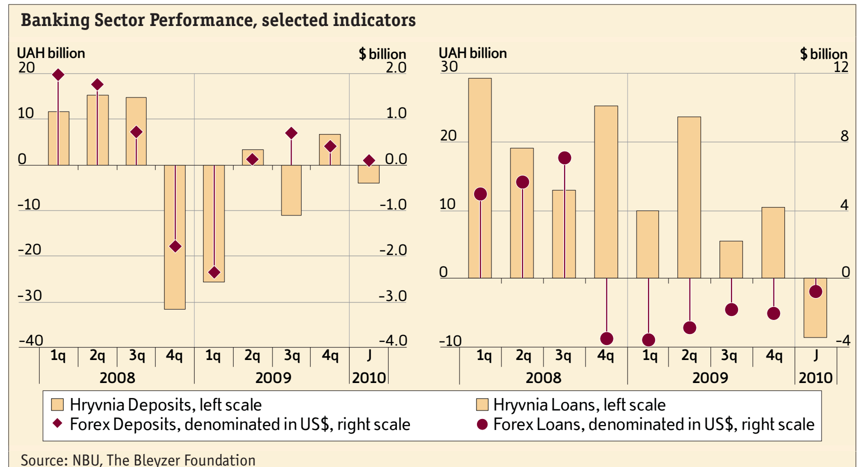
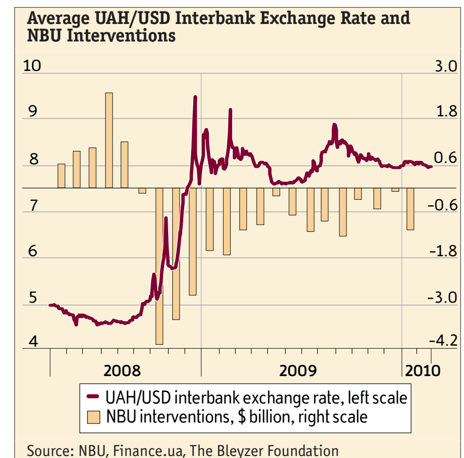
cember 2009), the government keeps crowding out commercial banks' credit to the economy. In addition, the NBU continued to sell international reserves to support Hryvnia, extract liquidity from the banking system through its certificate of deposits facility (UAH 16.6 billion in January 2010) and provide limited refinancing resources (UAH 1.4 billion) causing the monetary base to decline by 2.8% mom in January. As a result, the stock of commercial banks' credit fell by 2% mom over the period. At the same time, amid improved political stability (likely in the second half of 2010), easing pressures on the Hryvnia exchange rate, and continuing progress in bank recapitalization (both with public and shareholder funds) may start to recover in the second half of 2010.



Despite the election campaign, the Ukrainian foreign exchange market was calm during January-February 2010. Over the period, the exchange rate was virtually stable at about UAH 8.0 per USD. The stability was the result of tight liquidity in the banking sector, continuing NBU support, but mainly due to an improving current account balance and easing external debt financing needs. The strained situation with public financing and limited sources of fiscal deficit financing are the largest risks for exchange rate and inflation developments in 2010. However, assuming the IMF program is back on track in mid-2010, these risks are likely to be successfully controlled.



International Trade and Capital

Due to a sharp cooling of the previously overheated economy, Ukraine's external imbalances narrowed considerably. Prompt actions of the Ukrainian authorities to contain and weather the financial crisis during late 2008/the first half of 2009 helped to reduce a number of Ukraine's vulnerabilities. Although exports of goods slumped by 40% yoy in 2009, a large contraction in domestic consumption and investment caused an even deeper decline in imports- about 45% yoy. As a result, the current account deficit narrowed from 7% of GDP in 2008 to about 1.7% of GDP in 2009. The current account is forecast to remain in small deficit in 2010 given the moderate recovery of domestic demand, more expensive energy imports, but good export prospects.

Unlike the current account, the financial account turned strongly negative in late 2008/2009 on the back of high external debt repayments and large population demand for foreign currency. At the same time, disbursements of the two tranches under the IMF stand-by agreement in the amount of $6.1 billion, financial support of other IFIs (such as WB, EBRD, etc.) helped to smooth Ukraine's external financing needs in 2009. Although the IMF program was put off-track in the fall of 2009, foreign creditors continued to roll-over Ukraine's debt due to large investments already made to Ukraine, improved financial positions of their home offices and good long-term potential of the Ukrainian economy. As a result, the private external debt rollover ratio stood at a solid 82% in 2009. Although Ukraine's external financing needs remain high in 2010 (estimated at about $25 billion), they will be manageable with the resumption of the IMF program and likely high debt roll-over ratio.

The January 2010 preliminary external sector statistics were encouraging and supportive of our forecast. Indeed, export of goods grew by 23.5% yoy, driven by improved external demand for steel products, mineral goods and machinery (exports of these commodities were up by 26% yoy, 82% yoy and 21% yoy respectively). At the same time, imports surged by 67% yoy. While a low statistical base effect played a substantial role for both exports and imports, the high growth of imports is mainly explained by increased prices for imported energy resources. Thus, imports of mineral products were up by an impressive 153% yoy. However, thanks to a larger surplus in foreign trade of services, the current account was in a small surplus of $230 million in January 2010. Although the financial account remained in deficit due to private sector external debt repayments, it notably narrowed compared to the respective period last year. The slightly lower external debt roll-over ratio (63%) may be explained by political instability related to presidential elections and is forecast to increase as political tension abates.

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