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- Export-led real GDP growth was estimated at around 5% yoy in 1Q 2010.
- Public finances remain strained with expenditure growth notably outpacing the increase in revenues.
- On April 27<sup>th</sup> 2010, the parliament approved the 2010 state budget law with a targeted deficit of 5.3% of GDP. But there is a risk the broad fiscal deficit may be much higher.
- Amid improving export opportunities and restoration of foreign investors' interest to Ukraine, the current account was virtually balanced in 1Q 2010 while the capital account turned into a large surplus in March 2010.
- Thanks to a number of favorable factors, we have revised upwards the forecast of main macroeconomic indicators for Ukraine in 2010.

### Executive Summary

Following the victory of the opposition leader Victor Yanukovych in February's 2010 presidential elections, a new ruling coalition was formed in the Ukrainian parliament and a new government headed by Prime Minister Mykola Azarov was approved. The formation of a coalition based on individual deputies has been challenged in the Constitutional Court, as the Constitution requires a coalition of political parties. On April 8<sup>th</sup>, the Court ruled the coalition legal. Although the decision looked controversial, it was an important factor for gaining political stability in the country. The new government declared its willingness to introduce a number of structural reforms. For these purposes, a number of reform committees were created. Although PM Azarov and other members of the government are not considered reformers, it appears the new government has the expertise required to take measures to prevent further economic unrest.

Being a very open economy, Ukraine has benefited from the ongoing recovery of the world economy. Driven by export-oriented industries and their related sectors (cargo transportation and wholesale trade), real GDP was estimated to increase by about 5% yoy in 1Q 2010. On the back of slow domestic demand strengthening and delays in natural gas tariff adjustment, Ukraine's consumer price inflation decelerated to 11% yoy in March. The improving economic and political situation in Ukraine and resuming risk appetite of foreign investors allowed Ukrainian banks and companies to re-open foreign capital markets. This, in

turn, contributed to the easing of Ukraine's external financing needs and may stimulate a faster recovery.

Public finances remained under significant strain during the first three months of 2010. Despite a stronger recovery, budget revenues performance was rather weak. As fiscal austerity measures during presidential elections looked problematic and there was a need to realize some pre-election promises after the elections, budget expenditures grew at a robust pace. As a result, the consolidated budget deficit amounted to 2% of GDP in 1Q 2010. However, the official deficit did not include Pension Fund and Naftogaz imbalances as well as bank recapitalization spending; hence, the broad fiscal deficit was estimated at about 7-8% of GDP. The deficit was primarily financed by new domestic borrowing. The lion's share of government T-bills was purchased by the NBU, implying indirect monetization of the budget deficit.

On April 27<sup>th</sup>, the parliament approved the 2010 state budget law with a deficit of 5.3% of forecasted GDP. The budget was developed based on a realistic macroeconomic forecast and included a realistic Pension Fund deficit. However, the broad fiscal deficit may still be much higher as Naftogaz financing needs remain unclear and the budget law contains a number of provisions that may lift the deficit upwards. A high 2010 fiscal deficit and rising sovereign debt increases worries over government solvency and represents a major risk to financial stability over the medium-term.

	2005	2006	2007	2008	2009	2010*
GDP growth, % yoy	2.7	7.3	7.9	2.1	-15.1	4.5
GDP per capita, \$	1 830	2 300	3 070	3 870	2 540	3 060
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 <sup>†</sup>	-2.1 <sup>†</sup>	-8.5 <sup>††</sup>	-6.0 <sup>‡</sup>
Government external debt, % GDP	13.7	11.0	8.7	9.3	20.5	20.0
Inflation, eop	10.3	11.6	16.6	16.6	12.3	13.0
Gross international reserves, \$ billion	19.4	22.4	32.5	31.5	26.5	28.0
Current account balance, % GDP	2.9	-1.5	-3.7	-7.0	-1.7	2.0
Gross external debt, % GDP	45.9	50.6	56.0	56.4	88.6	75.0
Exchange rate, Hryvnia/US Dollar, eop	5.1	5.1	5.1	7.7	7.99	7.8-8.0

\*Projections <sup>†</sup>Including implicit pension fund deficit <sup>††</sup>Including bank recapitalization and Naftogaz capital injection, implicit pension fund deficit and expenditures covered by IMF's special SDR allocation <sup>‡</sup>Including Naftogaz, Pension fund deficit (not including bank recapitalization expenditures)

Sources: State Statistics Committee of Ukraine, NBU, Ministry of Finance of Ukraine, 2010 Budget Law, The Bleyzer Foundation

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### Economic Growth

Real sector data for the first three months of 2010 shows that the economic recovery in Ukraine has been gaining strength. Moreover, stronger-than-expected growth in the global economy, driven primarily by emerging Asia and Latin America, larger social transfers to the population approved in the 2010 budget law and a lower price for imported natural gas (renegotiated with Russia in mid-April) led us to upgrade the 2010 macroeconomic forecast for Ukraine.

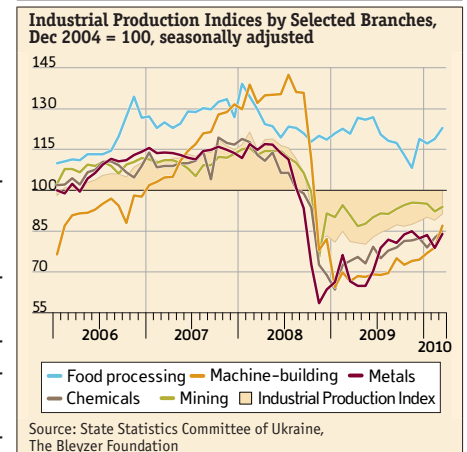
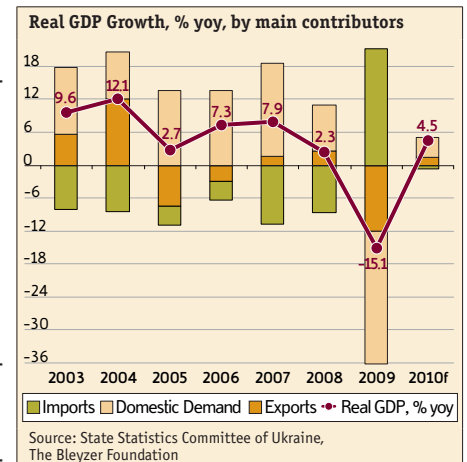
According to revised State Statistics Committee data, economic activity fell by 15.1% yoy in 2009. The high degree of openness of the Ukrainian economy, with relatively undiversified exports representing about 50% of GDP, made the country vulnerable to the contraction in global trade. However, an even larger negative contribution to GDP growth in 2009 was made by domestic demand. An abrupt credit squeeze on both foreign and domestic capital markets, increased unemployment, reduction in real wages and sharp Hryvnia depreciation in the fall of 2008 triggered sizable declines in consumption and investment. On a positive note, the slump in domestic demand brought an abrupt retrenchment of imports, while Hryvnia depreciation helped to restore competitiveness of the Ukrainian exports.

Already in the second quarter of 2009, Ukraine showed the first signs of improvement, which strengthened in the second half of the year. Positive developments continued to gain momentum in the first three months of 2010. The recovery was concentrated in export-oriented industries, favored by strong demand from vigorously recovering emerging markets (particularly in Asia and Latin America). Thus, a strong commodity price upswing benefited Ukraine's chemical production, metallurgy and closely linked extraction and coke products industries. Output in the respective industries was up by about 26% yoy, 18% yoy, 24% yoy and 13% yoy over January-March 2010. The continuing strong rebound in the Russian Federation, the principal market for Ukraine's machinery exports, underpinned a 26% yoy increase in Ukrainian machine-building. All in all, the period saw an 11% yoy increase in industrial production.

At the same time, the growth in industrial production and foreign trade propelled the rise in service sector activity. Cargo transportation turnover went up by a solid 16% yoy in January-March 2010; wholesale trade turnover advanced by 2% yoy. On the downside, a continuing decline in retail trade and passenger transportation turnover (-3% yoy and -5% yoy respectively over the first three months of 2010) and the ongoing downsizing of the construction sector (-21% yoy over the period) indicate that domestic demand remained weak. At the same time, fragile domestic demand helped to keep import growth subdued. All in all, taking advantage of favorable external conditions and low statistical base, real GDP was estimated to grow by about 5% yoy in 1Q 2010.

While the base effect, particularly powerful in the first half of the year, will fade through the rest of the year and commercial banks' weaknesses will continue to restrain consumption and investment growth, we have revised upwards Ukraine's real GDP growth forecast to 4.5% in 2010. The revision was based on the back of upside realization of several risks to the previous forecast. First, a faster-than-expected rebound in the global economy, driven primarily by BRIC countries, improved prospects for world trade growth in 2010.

Second, at the end of March 2010, world exporters' switched to a quarterly-based iron ore pricing mechanism from an annual benchmark. The change will pressure world steel prices upwards, as iron ore is the main ingredient in steelmaking. Following a 3% monthly growth on average over the first three months of 2010, global steel prices were up by 11% in

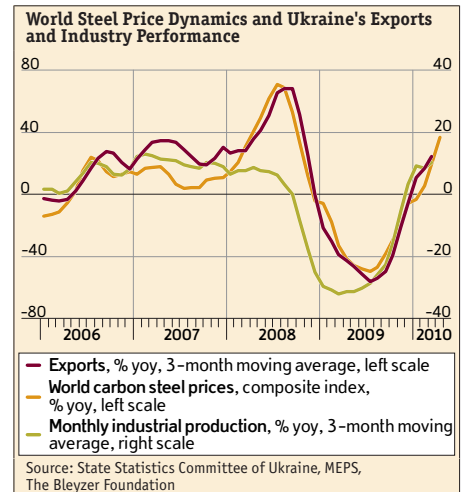


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April 2010 compared to the previous month, according to MEPS<sup>1</sup>, and are likely to increase further. These price developments will favor Ukrainian producers, as the country is the eighth largest steel producer and the fourth largest steel products exporter and Ukraine's steel makers have a high degree of raw material self-sufficiency.

Third, on April 21<sup>st</sup>, Ukraine and Russia agreed on a 30% discount on the price of imported gas to Ukraine. Thus, the average price for imported gas is now estimated at about \$245 per 1000 m<sup>3</sup> in 2010 compared to the previous \$335 per 1000 m<sup>3</sup>. Lower gas prices will particularly benefit the natural gas-intensive chemical industry and metallurgy, thus giving stronger impetus to the recovery of the Ukrainian economy. Fourth, higher social expenditures, envisaged in the 2010 budget law, should support households' purchasing power, although tight credit and expected higher inflation will continue to suppress the recovery in private consumption.

Finally, on the back of foreign investors' resuming risk appetite and the improving economic and political situation in Ukraine, Ukraine seems to be regaining access to foreign capital markets. Following the successful debut of state-owned Ukreximbank and energy company DTEK in issuing Eurobonds in mid-April, with foreign investors' demand exceeding supply by about 8 and 3 times respectively, a number of other companies announced their plans to resume foreign borrowing. Thus, new external borrowing arrangements may bring about \$4 billion to Ukraine in 2010. Given tight domestic credit, these funds may spur private investments.



### Fiscal Policy

Despite the ongoing recovery, Ukrainian public finances remain under significant pressure. Over the first three months of 2010, consolidated budget revenues totaled UAH 67 billion (\$8.4 billion), only 2.2% yoy higher in nominal terms. To a significant extent, modest growth of budget revenues over the first three months of 2010 is explained by extensive practice of advance tax collections in 2009. However, even this modest increase was achieved on the back of further accumulation of VAT refund arrears, a low base effect and the NBU transfer of part of its profits received in 2009 to state coffers.

Thus, Ukraine collected UAH 22.3 billion (\$2.8 billion) of VAT proceeds to the consolidated budget over January-March 2010, which was 4% lower than in 1Q 2009. The decline would have been much deeper if the VAT refund was fully executed. Instead, VAT refund arrears grew by about 30% during the first three months of the year and reached UAH 28.4 billion (\$3.6 billion) at the end of March 2010. A roughly 50% yoy nominal increase in excises should be primarily attributed to a low base effect, as Ukraine notably raised excise duties on tobacco and alcohol during 2009. Personal income tax receipts grew by 9% relative to 1Q 2009, backed by a 17% yoy increase in average wages over the respective period. At the end of

	2009*		2010f		3m 2010	
	UAH billion	% yoy	UAH billion	% yoy	UAH billion	% yoy
<b>Total Revenues</b>	<b>209.7</b>	<b>-9.5</b>	<b>267.5</b>	<b>27.6</b>	<b>51.7</b>	<b>0.9</b>
Tax revenues	148.9	-11.3	203	36.3	38.1	7.3
EPT	32.6	-31.4	40.5	24.2	9.3	27.6
VAT	84.6	-8.1	119	40.7	21.3	-4.1
Excises	21.3	67.8	29.7	39.4	5.2	41
Non-tax revenues	50.7	-4.1	55.4	9.3	11.3	-19.3
NBU profits transfer	4.6 <sup>††</sup>	-	10	-	1	-
<b>Total Expenditures**</b>	<b>242.4</b>	<b>0.4</b>	<b>323.6</b>	<b>33.5</b>	<b>57.4</b>	<b>12.6</b>
Consumer expenditures	232	7.5			56.5	12.3
Capital expenditures	10.4	-59.3			0.9	41
Official Pension fund deficit	14	-	29.6	-	-	-
<b>Budget deficit†</b>	<b>35.5</b>	<b>3.9%</b>	<b>57.8</b>	<b>5.3%</b>	<b>5.5</b>	<b>2.4%***</b>
<b>Deficit financing</b>						
Net domestic borrowing	44.9		49.1		17.2	
Net external borrowing	44.8		27.3		-1.4	
Privatization receipts	0.8		10		0.1	

\* Revised data (SDR allocation was excluded from Budget revenues)  
 \*\* Not including net credit from the budget  
 † % of GDP for budget deficit  
 †† Estimate  
 Source: Ministry of Finance, 2010 Budget Law, The Bleyzer Foundation

<sup>1</sup>MEPS (International) LTD is a British based consultancy company operating in the steel sector, an independent supplier of the steel market information.



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1Q 2010, the NBU conveyed UAH 1 billion (\$0.13 billion) of its 2009 profits to the state budget, although the transfer was scheduled for 2Q 2010.

On the upside, enterprise profit tax proceeds showed an almost 27% yoy increase in 1Q 2010. It is likely that such remarkable growth was achieved thanks to improved tax administration and tax compliance, as official statistics reported a relatively moderate increase in corporate profits before taxes (+8.4% yoy over January-February 2010). However, the continuing practice of collecting taxes in advance looks more probable.

A high 2009 fiscal deficit and modest budget revenue growth in the first months of 2010 signaled an urgent need for fiscal consolidation measures. However, due to inherent budget expenditure rigidities and some escalation of spending pressures ahead and after the presidential elections (due to the need to realize pre-election promises), consolidated budget expenditures grew at a much faster pace of 10% yoy in January-March 2010. Thus, spending on public sector wages and social transfers to the population went up by about 15% yoy. At the same time, to prevent the deficit going out of control, the government has cut capital expenditures by a nominal 22% yoy over the period. Given the disparity in budget revenue and expenditure growth, the consolidated budget gap was reported at UAH 4.4 billion or about 2% of estimated period GDP for January-March 2010. However, the broad fiscal deficit was more sizable due to ongoing deterioration of Ukraine's Pension Fund performance, the difficult financial stance of state-owned gas monopoly Naftogaz and bank recapitalization needs.

Robust nominal wage growth (up by 17% yoy over the first quarter of 2010) allowed the Pension Fund to collect 12% more revenues compared to the respective period last year. However, its own resources were insufficient to cover all pension expenditures, which grew by 11% yoy over the period. As a result, the pension fund deficit amounted to UAH 7 billion (\$0.9 billion) in 1Q 2010, the lion's share of which (72%) was covered by new borrowings from the state budget.

The Ukrainian authorities denied payment difficulties for imported natural gas and there are few official details on the issue. However, concerns over the financial stance of Naftogaz have been strengthening. With natural gas tariffs to the population and utility sector set much lower than the market price, Naftogaz ended 2009 with an operational deficit estimated at about 2.7% of GDP. Although the price for imported natural gas rose to \$305 per 1000 m<sup>3</sup> in 1q 2010 and was set to increase further to \$330 per 1000 m<sup>3</sup> in 2q 2010, the government remained reluctant to raise natural gas tariffs. Although the difference was partially compensated for in the state budget, the company had to rely on state-owned banks' credit and other (principally one-off) sources of funds. The new Russian-Ukrainian gas discount deal brought some relief to Naftogaz concerns. However, the estimated average price for natural gas at about \$245 per 1000 m<sup>3</sup> for 2010 is still higher than the average price for 2009 (\$228 per 1000 m<sup>3</sup>). Thus, without raising natural gas tariffs, sustaining Naftogaz finances looks quite problematic.

In March 2010, the government issued UAH 4.6 billion (\$0.6 billion) of domestic debt securities to recapitalize state-owned Ukreximbank, which will be monetized by the NBU during the year. Hence, the overall fiscal deficit was estimated at around 7% of GDP in 1Q 2010 and was covered by new domestic borrowings. Although foreign investors' interest in Ukraine's domestic T-bills has notably increased this year on the back of ongoing world economic recovery and improving economic and political situation in Ukraine, the NBU remained the principal purchaser of domestic debt securities. As a result, Ukraine's domestic public and publicly guaranteed (PPG) debt grew by about 17% from January to March 2010. In the absence of new foreign borrowings, Ukraine's foreign PPG debt declined by 3% over the period. Thus, total public and publicly guaranteed debt grew by 3% in January-March 2010 to \$41.3 billion. Although the government debt-to-GDP ratio, standing at 35% of GDP at the end of 2009, is still considered low, it has virtually tripled in two years. Moreover, it is expected to further increase in 2010 due to a high fiscal deficit this year.



On April 27<sup>th</sup>, the 2010 state budget law was approved with a deficit of 5.3% of GDP. The budget was developed based on a quite realistic macroeconomic forecast of real GDP growth at 3.7% and consumer price index at 13.1% in 2010. At the

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same time, given an 18% nominal GDP increase and only 7% yoy increase in state budget revenues in the first three months of 2010, the tax revenue forecast of 36% in 2010 still looks overly optimistic. On the other hand, the government is going to tighten tax administration and increase excises on alcohol, tobacco and gasoline products and some other duties.<sup>2</sup> According to government estimates, the realization of these initiatives should bring an additional UAH 16 billion to the budget, thus making the revenue target achievable.

On the expenditure side, the budget envisages about UAH 22 billion for the implementation of the Law on Increases in Social Standards,<sup>3</sup> approved at the end of October 2009. Last year, the approval of this law led to a suspension of the IMF program with Ukraine as its full implementation would have ballooned the fiscal deficit. The differentiation between the minimum wage and the first rank in the Unified Labor Tariff Scale system allowed the government to relatively moderately raise its social liabilities in 2010. In the budget, the government foresaw rather realistic expenditures to cover the Pension Fund deficit, forecasted at UAH 29.5 billion (\$3.7 billion). Amid a rapidly aging society, Ukraine's pension system becomes an increasingly heavy burden for the state budget and the economy as a whole, urging for prompt reform measures. The new authorities declared their willingness to introduce a number of structural reforms, including social security reform. So far, however, it is too early to conclude whether the necessary changes will be implemented.

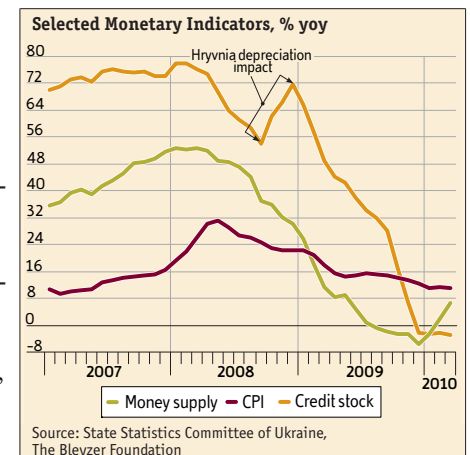
While the approved budget deficit of 5.3% of GDP includes expenditures to fully cover the forecasted pension fund deficit, the size of the financial support to Naftogaz remains unclear. As noted above, with the natural gas tariffs for the population and utility sector announced to remain unchanged, the Naftogaz deficit is unlikely to be much less than in 2009. Hence, it would be a challenging task to convince the IMF that Ukraine will meet the requirement of keeping the 2010 fiscal deficit (including Pension fund and Naftogaz imbalances) at 6% of GDP. Moreover, due to a number of provisions in the budget law (UAH 45 billion (\$5.6 billion) of state guarantees, additional expenditures to finance local elections if the latter are held in 2010<sup>4</sup>, UAH 5 billion to credit Agricultural Fund, etc.) there is a risk the size of the broad fiscal deficit may be much higher. Thus, a high fiscal deficit in 2010 and rising sovereign debt increase worries over government solvency and represent the major risk to financial stability over the medium-term.

### Monetary Policy

As natural gas and utility tariff increases are delayed, the exchange rate remains stable and demand-side pressures are still weak, consumer price inflation kept moving on a downward path. In annual terms, consumer price index growth decelerated to 11% in March 2010. At the same time, planned excise increases, rising world energy and commodity prices, the revival of economic activity and finally indirect monetization of Ukraine's large fiscal deficit will pressure prices upwards. Thus, inflation is expected to rise to 13-15% at the end of 2010.

The end of the presidential election campaign, formation of the new government, an improving current account balance, easing external debt financing needs, and continuing NBU interventions kept the foreign exchange market stable in March-April 2010. Moreover, foreign investors' revived interest in Ukraine resulted in the foreign currency supply exceeding demand in March 2010. This pressured the Hryvnia exchange rate to appreciate with respect to the US Dollar to UAH 7.93 per USD. However, the NBU did not allow the exchange rate to appreciate further by buying out the surplus of foreign currency. For the first time since August 2008, net NBU foreign exchange interventions were positive and reached almost \$1 billion in March 2010. This allowed the NBU to replenish its gross international reserves to \$25.1 billion.

Due to the NBU purchase of foreign currency, repayment of domestic T-bills, and recovering depositors' confidence, the liquidity stance of the Ukrainian banking system has notably improved in recent months. Although increasing government cash balances, sizable NBU sterilization operations and limited refinancing of commercial banks contained the



<sup>2</sup>The Draft Law #6337 "On Amendments to Certain Legislative Acts of Ukraine (regarding taxation)" was registered in the parliament on April 26<sup>th</sup>, 2010.

<sup>3</sup>The Law "On amending the Subsistence Level and the Minimum Wage" was approved on October 20<sup>th</sup>, 2009. The Unified Tariff Scale System was fully implemented in December 2009. As a result, it was the size of the first rank of the Scale rather than the minimum wage that was used as a basis for setting employees' wages. This allowed the government to avoid a multiplicative effect of minimum wage increase by raising those wages that were below the new minimum level.

<sup>4</sup>Actually, local elections should have been held on May 30<sup>th</sup>, 2010. However, due to the absence of a 2010 state budget law and, thus, inability to finance elections, they were abolished by the Verkhovna Rada in mid-February. So far, elections may be carried out either in the fall of 2010 or in spring 2011, with the latter looking more probable.

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growth of monetary aggregates, it notably accelerated in February-March 2010. Thus, the monetary base and money supply grew by 12.5% yoy and 6.6% yoy in March, compared to a 4.4% yoy growth and a 5.5% decline in December 2009 respectively. Amid the acceleration of monetary aggregates growth, the continuing sizeable, though indirect, monetization of the fiscal deficit may further worsen inflation developments and threaten foreign exchange stability.

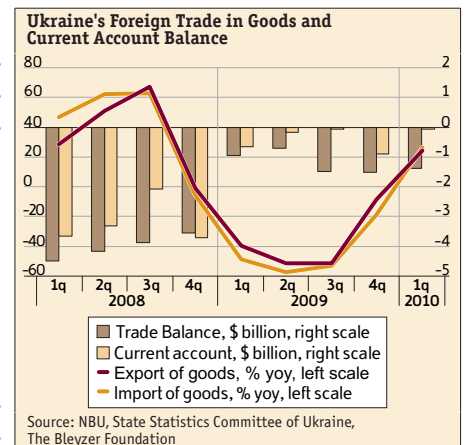
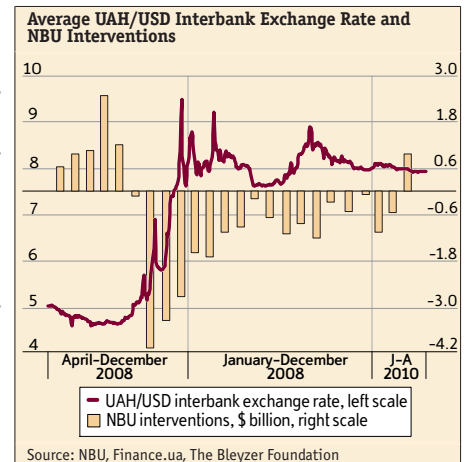
So far, despite improved banking sector liquidity, credit activity remains weak. The stock of commercial banks' loans to the economy of Ukraine keeps declining and was almost 3% yoy lower in March 2010. The decline was led by an almost 14% yoy drop in retail lending. The stock of bank credit to legal entities was 3.5% higher in March 2010 compared to the respective month a year ago but still a notable slowdown from an average 60% growth per year over 2005-2008. To some extent, the increase in corporate lending reflected government-induced loans to state-owned companies (like Naftogaz). Weak credit activity is attributed to the ongoing process of commercial banks' cleaning of their balance sheets and crowding-out with large domestic government borrowing. Amid recent strong evidence that the Ukrainian corporate sector and commercial banks are regaining access to foreign capital markets, commercial banks may choose to relax their lending policies in the coming months.

### International Trade and Capital

Growing world steel prices and recovering external demand for Ukraine's goods underpinned a 24% yoy growth in the value of Ukraine's merchandise exports in January-March 2010. Correspondingly, export of metallurgical products made the largest contribution to total export growth, rising by about 20% yoy. A strong rebound in the Russian Federation triggered a 35% yoy growth in export of machinery and equipment. Export of mineral and chemical products also demonstrated robust growth over the period.

Higher world commodity and energy prices as well as recovering economic activity in the country stimulated vigorous imports growth. Over January-March 2010, the value of Ukraine's merchandise imports grew by 26% yoy. As the growth of imports outpaced that of exports, Ukraine's foreign trade balance slightly worsened compared to 1Q 2009. Thus, the merchandise foreign trade deficit widened to \$1.4 billion in 1Q 2010 compared to less than \$1 billion a year before. At the same time, thanks to a higher surplus in foreign trade of services, Ukraine's current account was virtually balanced. Similar developments with some acceleration of imports in the second half of the year were forecast for the rest of the year. However, faster-than-expected world economic growth, changes in price-setting mechanism for iron ore trade in March 2010, which are forecasted to pressure world steel prices upwards, and a 30% discount on natural gas imports negotiated in April, prompted us to upgrade our current account balance forecast to a surplus of about 2% of GDP in 2010.

March's capital account data confirmed the revival of foreign investors' interest in Ukraine. Net inflow of foreign direct investment (FDI) accelerated to \$0.5 billion that month compared to about a \$0.3 billion monthly average during the previous two months of 2010 and in 1Q 2009. External private debt roll-over ratios surged to 103% and 134% for commercial banks and the corporate sector respectively. Furthermore, thanks to foreign exchange stability and even some Hryvnia appreciation, population demand for foreign currency notably declined. All of this resulted in a capital account surplus of about \$1.3 billion in March 2010. Successful corporate and commercial bank placements of Eurobonds in April 2010 are additional evidence of Ukraine's eased external debt financing needs. This gave us reason to revise our foreign exchange rate forecast to UAH 7.8-8.0 per US Dollar.



Ukraine's Balance of Payments, selected indicators		
	1q 2009	1q 2010
<b>Current account, \$ billion</b>	-0.7	-0.1
Exports of goods, % yoy	-39.4	24.2
Imports of goods, % tot	-49	26.1
<b>Capital &amp; financial account (analytical representation), \$ billion</b>	-4.6	-0.6
Net FDI, \$ billion	0.9	1
<b>Debt roll-over ratio, %, o/w</b>	<b>85</b>	<b>79</b>
Banking sector	78	77
Corporate sector	105	82

Source: NBU

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