Ukraine

Macroeconomic Situation

September 2010

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- **In August 2010, industrial production growth accelerated to 9.2% yoy.**
- **Despite unfavorable weather conditions and a decline in output, the agricultural sector of Ukraine looks promising as the country is forecast to produce above-average harvest in 2010.**
- **Ukraine successfully placed Eurobonds totaling $2 billion in mid-September.**
- **Annual consumer inflation accelerated to 8.3% in August (up from 6.8% yoy in July), spurred by soaring world food prices, a natural gas tariff adjustment and domestic supply shortages.**
- **The foreign exchange market was more volatile in September due to the seasonal surge in forex demand and a softer tone in the NBU intervention policy.**
- **The current account balance worsened in August, affected by further widening in the foreign trade deficit.**
- **Despite significant reduction in external vulnerability during 2009-2010, Ukraine needs to keep foreign investors' confidence high as short-term gross external debt financing needs remain substantial.**

Executive Summary

In August 2010, Ukraine's real sector growth strengthened thanks to a better external environment and continuing recovery of domestic consumption. While the performance in metallurgy and its closely tied industries improved, the growth in industrial production was led by machine-building, food-processing and the chemical industry. A further increase in the population's purchasing power (thanks to continuing growth in real monthly wage and high social transfers) and improved budget financing of infrastructure projects underpinned further recovery in retail sales and construction respectively.

Despite unfavorable weather conditions, Ukraine is forecast to produce about 39 million tons of grains in 2010, above average for the last 10-15 years. However, this year harvest was lower compared to plentiful ones in 2008 and 2009. Hence, as it was anticipated the agricultural sector performance worsened in August. The sector reported a 4.1% yoy decline for January-August. Possessing very fertile soils, Ukraine may become one of the largest grain producers and exporters if local agricultural firms are better equipped and fertilizer usage is improved.

Until recently, the strained situation with public finances was one of the major risks for Ukraine as budget revenues were recovering slower than expected, while expenditures kept rising quickly. In addition, due to still tight access to foreign financing, Ukraine continued to rapidly accumulate domestic public debt. The resumption of IMF cooperation reduced fiscal deficit concerns and increased foreign investor confidence. As result, in mid-September, Ukraine successfully placed Eurobonds totaling $2 billion at an attractive cost.

Following several months of stability, the foreign exchange market of Ukraine became more volatile in September. At the same time, macroeconomic fundamentals remain strong enough to keep the exchange rate at the forecast UAH 7.9-8.0 per USD through the end of the year. September's volatility may be attributed to a change in the NBU intervention policy, as Ukraine committed to the IMF to allow greater foreign exchange rate flexibility, a seasonal increase in foreign currency demand and some worsening of Ukraine's balance of payments (wider current account deficit and larger external private debt repayments).

	2005	2006	2007	2008	2009	2010*
GDP growth, % yoy	2.7	7.3	7.9	2.1	-15.1	4.0
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†	-2.1†	-8.5††	-6.5‡
Government external debt, % GDP	13.7	11.0	8.7	9.3	20.5	21.5
Inflation, eop	10.3	11.6	16.6	16.6	12.3	10.0
Gross international reserves, $ billion	19.4	22.4	32.5	31.5	26.5	34.0
Current account balance, % GDP	2.9	-1.5	-3.7	-7.0	-1.7	-0.5
Gross external debt, % GDP	45.9	50.6	56.0	56.4	88.6	78.5
Exchange rate, Hryvnia/US Dollar, eop	5.1	5.1	5.1	7.7	7.99	7.8-8.0

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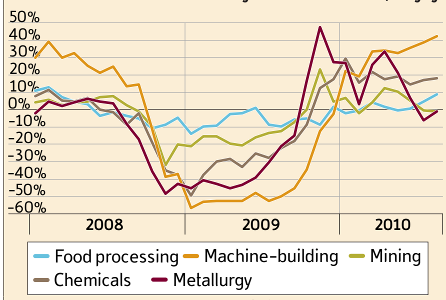
Economic Growth

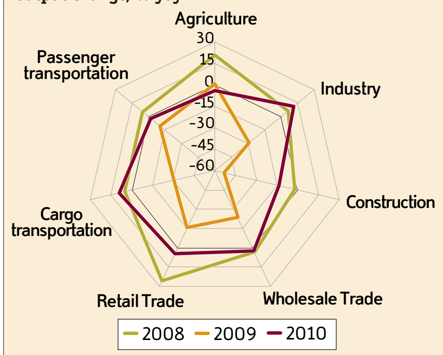
Following weaker performance in July, Ukraine's real sector growth strengthened in August amid a better external environment and continuing recovery of domestic consumption. Thus, industrial production rose by 9.2% yoy in August after 6.4% yoy in the previous month. At the same time, as the effect of low statistical base has started to vanish, cumulative growth kept moderating to 10.9% yoy over January-August.

Industrial Production Growth by Selected Branches, % yoy



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Ukraine's Real Sector Performance over January-August, output change, % yoy



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Resumed growth of world steel prices since mid-July allowed Ukraine to increase metallurgical production by 5.5% in August compared to the previous month. However, due to a stronger statistical base effect, the sector's output production was still 1% lower than in August last year. Rather cautious expansion in the industry may be attributed to an uncertain near-term outlook for the world steel market due to weaker forecasted growth of the global economy in 2H 2010, relatively large accumulated inventories and evidence that world steel production is recovering faster than demand.

The continuing robust recovery in Russia and closer relations the country (rapprochement with Russia was one of the election promises of the new Ukrainian president who came to power in February 2010) benefited Ukraine's machinery and transport equipment industry. Russia accounts for more than 50% of Ukraine's machinery and transport equipment exports. The industry's output grew by 42% yoy, bringing cumulative growth to about 33% over the first eight months of 2010.

A lower global grain harvest in 2010 due to unfavorable weather that damaged crops in a number of countries (droughts in Russia and some European countries, floods in Canada, China, Pakistan and other parts of Central and South-East Asia etc.) caused world food prices to soar and boosted demand for fertilizers by the start of the new planting season. Thus, the Ukrainian chemical industry, dominated by fertilizers, went up by 18% yoy in August 2010. The industry gained more than 20% on an annual basis over the first eight months of the year.

Improving domestic spending also helped Ukrainian producers. Thanks to better budget financing of infrastructure projects (primarily on Euro 2012 football championship projects), the decline in the construction sector eased to a cumulative 14% yoy for January-August 2010. Continuing growth of real monthly wages (up by 9.3% yoy over the first seven months of 2010) supported an almost 9% yoy and 6% yoy growth in domestic market-oriented food-processing and light industry in August 2010, respectively. Retail sales turnover grew by 4.6% yoy over January-August, up from 4% yoy in January-July. At the same time, intensified inflation pressures since August and still weak credit activity are likely to restrain the pace of recovery of consumer purchasing power for the rest of the year.

As it was anticipated, agricultural performance kept worsening. The sector reported a 4.1% yoy cumulative decline for January-August 2010, down from 0.6% yoy in the first seven months of the year, as Ukraine's crops also suffered from unfavorable weather conditions. As of September 27th, Ukraine had harvested about 34 million tons of grain, which is almost 12% lower than in the respective period last year. Since mid-September, the government estimates grain production at 39 million tons in 2010, down from the previous forecast of 42 million tons. Though, this year harvest looks rather poor compared to the plentiful 53.3 million and 46 million tons of grain produced in 2008-2009, it is higher than average for the last 10-15 years. Moreover, Ukraine has a potential to become the world's second largest agricultural player. Possessing fertile black earth soils and having generally favorable climate for agriculture, Ukraine may at least double her production of grains if local agricultural firms are better equipped and managed and fertilizer usage is improved. With domestic consumption of about 20 million tons, Ukraine's grain export potential may be then comparable to that of the United States.[1]

In the meantime, even with the relatively small share in total GDP (about 7% in 2009), agriculture remains one of the most important sectors in Ukraine as many other sectors are tied to it. Indeed, lower grain harvest as well as indirect constraints for grain exports were

[1] There are a number of countries that are very large producers of grains (the USA, China, India, etc.). However, many of these countries consume internally most of their output. In 2009, the United States produced about 420 million tons and exported about 80 million tons of grains.

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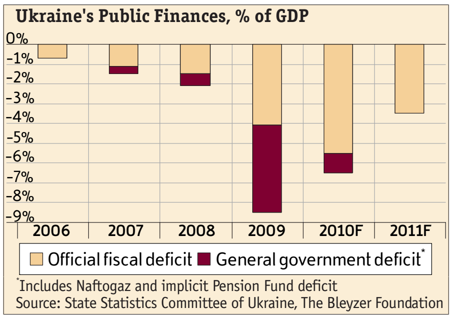
among the main reasons for growth deceleration in cargo transportation and wholesale trade turnover. The sectors grew by 9.4% yoy and 2.8% yoy over January-August compared to 10.9% yoy and 4.3% yoy in January-July 2010 respectively. At the same time, as worse agricultural performance and the vanishing low statistical base effect in 2H 2010 were anticipated, we maintain our full-year real GDP forecast at about 4% yoy in 2010.

Fiscal Policy



The approval of the new IMF loan program in July 2010 was key in reducing fiscal sustainability risks in Ukraine. In 2009, high fiscal financing needs (as the general government deficit reached about 8.5% of GDP) were covered thanks to domestic borrowing and IMF credit. However, since late 2009 it was off-track due to weaker implementation of policy measures in the run-up to the presidential elections. In April 2010, the state budget for this year was approved targeting a lower deficit of 5.3% of GDP. However, slower than forecasted recovery of budget revenues amid fast growth of expenditures and delays in the natural gas tariff adjustment, necessary to contain the Naftogaz deficit, put the feasibility of the approved deficit target at risk. Indeed, the state budget fiscal deficit reached UAH 26.5 billion, or about 5.5% of estimated period GDP. In addition, amid still tight access to foreign financing and poor privatization progress, the deficit led to further accumulation of domestic public debt. Furthermore, as the NBU and commercial banks were the main purchasers of government debt securities, this led to acceleration of money supply growth amid moderate money demand and bank credit rationing. Finally, slow resolution of large VAT refund arrears has negatively affected fiscal performance and undermined foreign investors' confidence.

To qualify for the IMF funds, Ukraine demonstrated a strong commitment to IMF requirements. In particular, the 2010 budget law was amended to make budget revenues more realistic and cut expenditures. These measures are expected to keep the state budget deficit at 5.5% of GDP. Natural gas tariffs for the population and heating companies were raised by 50% since August 2010 and the government agreed to raise them by another 50% in April 2011. Some progress was achieved in implementing structural reforms,[2] which are seen as an essential element for successful fiscal adjustment.

The above measures helped to contain the widening of the fiscal deficit already in July 2010. Preliminary data for August showed further improvement in budget revenue collections. At the same time, some further widening in budget deficit may be expected in the coming months as the government has a commitment to reduce the stock of VAT refund arrears to about UAH 3 billion as of end-September.[3]

The resumption of cooperation with the IMF helped to reduce government deficit financing needs (about $2 billion out of IMF funds in 2010 will be available to finance the budget deficit), and also helped increase investor confidence. In mid-September 2010, the government successfully placed $2 billion in Eurobonds in two offerings: $500 million in five-year bonds yielding 6.875% pa and $1.5 billion in ten-year bonds yielding 7.75% pa. A few months ago, the government withdrew Eurobonds issuance as the proposed yields by potential investors were much higher than planned by the Ukrainian authorities. While in 2010-2011 Ukraine's public and publicly guaranteed debt is set to further increase, the continuation of the IMF program, envisaging a reduction of the fiscal deficit to 2.5% of GDP in 2012, will allow public debt to return on a declining path.

Monetary Policy

Following four months of deflation (in monthly terms), in August consumer prices grew by 1.2% month-over-month (mom), an unusual surge for this summer month for the last ten years. The increase was the result of a rise in utility tariffs (on August 1st, natural gas tariffs for the population rose by 50%) as well as higher excises on alcohol and tobacco. In addition, domestic food prices experienced growing pressure from soaring world prices. Thus, domestic sugar prices grew by 5.5% over July-August. Although Ukraine is fore-

[2] The measures included: adoption of a new gas law that would gradually liberalize the gas sector, approval of a new Procurement Law, improvement of the business regulatory framework by reducing the number of licenses and simplifying procedures for obtaining them, and adoption of a new Budget Code, allowing for greater fiscal decentralization. The government has also developed a new draft Tax Code.

[3] During the first seven months of 2010, VAT reimbursement was limited as the government was auditing VAT refund arrears accumulated prior to 2010, was elaborating a mechanism of converting them into government VAT bonds and was developing an automatic VAT refund system. As the latter required time, the government kept accumulating new VAT arrears.

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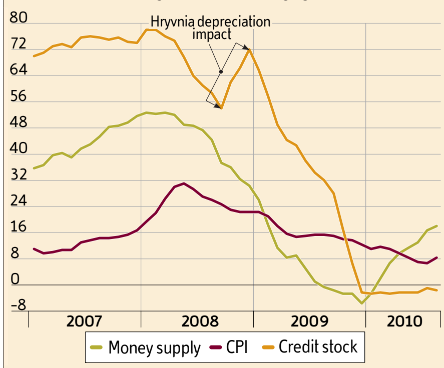
cast to have a much higher sugar harvest this year, domestic sugar price increases may reflect concerns over the global sugar supply[4], although seasonality also played a role.

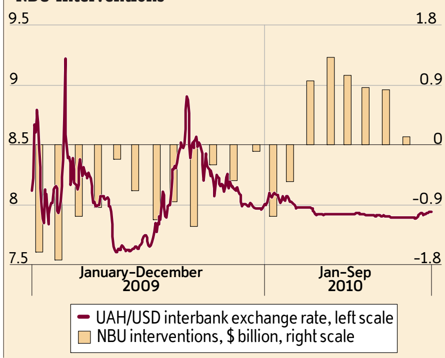
In addition, steady price growth on certain food products was driven by country-specific factors. Despite a plentiful grain harvest in 2008-2009, Ukraine's cattle breeding remains in deep crisis. Since 1990, the number of dairy cows fell from 8.5 million to about 2.7 million heads in 2009. Although it stopped declining in 2010 and even slightly increased, Ukraine faces persistent shortages of milk. Domestic shortages amid growing world dairy prices caused domestic prices on milk, butter and dairy products to return to an upward trend in August. Although pressure on domestic consumer prices is set to increase due to increases in the cost of public transportation services, a further rise in utility tariffs and continuing growth of world food prices, notable progress in reducing inflation observed in the first seven months allows us to keep our year-end inflation forecast at 10% for 2010. So far, consumer prices grew by 4.3% from January to August 2010.

Selected Monetary Indicators, % yoy



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Average UAH/USD Interbank Exchange Rate and NBU Interventions



Source: NBU, Finance.ua, The Bleyzer Foundation

Following a virtually stable exchange rate since February 2010, in September the market was more volatile. As a result, the Hryvnia marginally depreciated to UAH 7.91 per USD, up from UAH 7.89 per USD at the end of the previous month. Higher volatility was the result of a seasonal increase in demand for foreign currency (by the population and business), worsening of Ukraine's trade balance as well as lower NBU interventions in the market. Accustomed to daily NBU interventions, the market reacted nervously to the change in the NBU intervention policy, which may be partially explained by the commitment to the IMF to allow greater flexibility of the exchange rate market. As a result, the Hryvnia marginally depreciated to 7.94 per USD in mid-September, up from an average of UAH 7.89 per USD in August. At the same time, as the NBU kept smoothing volatility in the exchange rate market and the Ukrainian balance of payments position remains positive, the market calmed through the end of the month.

Higher exchange rate volatility during September 2010 may also be explained by accumulated excess liquidity in the banking system. On the back of robust growth in deposits (up by 19% yoy as of August 2010), loose monetary policy[5] and subdued credit activity, cash balances on commercial banks' correspondent accounts reached UAH 28 billion ($3.5 billion) in mid-September. Since July, the NBU has been actively sterilizing excess liquidity in the banking sector through its deposit certificate instrument. The NBU's reluctance to switch to tighter monetary policy (NBU deposit certificates are very short-term instrument of curbing liquidity) may be explained by the greater concern over the availability of bank credit to the economy rather than acceleration of inflation. This, in turn, may be the result of still weak credit activity (credit stock was down by almost 2% as of August 2010), seen as the main restraining factor for Ukraine's economic recovery, and mainly non-monetary nature of the recent upsurge in consumer price growth. With consumer prices forecast to grow by about 10% yoy in 2011 as well, reducing inflation to single digits, not observed since 2003, will finally be a priority for Ukraine as high inflation hampers both long-term investment and erodes competitiveness of Ukraine's products, while faster economic growth may be achieved by speeding up structural reforms.

International Trade and Capital

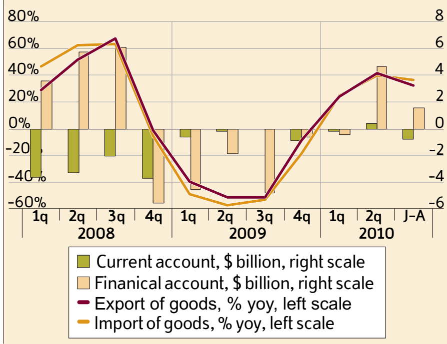
In August 2010, helped by resumed growth of world steel prices, strong Russian demand for heavy-duty vehicles and locomotives and buoyant demand for fertilizers, the growth of Ukraine's export of goods slightly accelerated to 32.7% yoy in August (up from 32.3% yoy in July). At the same time, exports might have conveyed better results if planned amounts of new harvest grains were fully exported that month. However, exports of agricultural products were up by a marginal 1.6% yoy in August according to preliminary NBU data, as exporters kept struggling with customs regulations enforced in July this year.

[4] While August's drought negatively affected sugar beets yields, Ukraine increased the sugar beets sown area by about 50% in 2010 compared to 2009. This expansion is explained by sugar shortages in 2009. In 2009, Ukraine produced only about 1.3 million tons of sugar. Given domestic demand at about 2 million tons and high imported prices on sugarcane, domestic sugar prices surged 2.3 times at the beginning of 2010. In 2010, Ukraine expects to produce about 1.8-1.9 million tons of sugar, hence the deficit should not be worrisome. At the same time, growing sugar prices in neighboring Russia and other countries may stimulate sugar exports.

[5] The NBU reduced its discount rate by 2.5 percentage points in three stages during the summer months to the current 7.75% pa. For most of this year, the real NBU discount rate was negative. In addition, a substantial portion of emergency financing received by commercial banks during the crisis was extended for longer periods. From March to August 2010, the NBU purchased more than $5 billion on the forex market, injecting Hryvnia liquidity. Finally, until recently the NBU was among the main purchaser of government domestic securities.

Much faster growth in commodity imports resulted in further worsening of Ukraine's foreign trade and current account balances. In August, the value of goods imports surged by 40.5% yoy driven by growing world commodity prices, larger volumes of imported energy resources, strengthening private consumption and replenishment of depleted stocks of imported goods (i.e., vehicles). As a result, the foreign trade deficit in goods widened to $3.9 billion for January-August 2010. At the same time, larger volumes of gas and crude oil transmission (up by 2.1 times for the first eight months of the year) secured a significant foreign trade surplus in services - $2.7 billion over January-August compared to $1.4 billion and $1.7 billion in the respective periods in 2009 and 2008 respectively. A larger foreign trade in services surplus allowed the current account deficit to widen moderately to $0.6 billion in August. Since the current account was balanced for the first seven months of 2010, the cumulative deficit also stood at $0.6 billion. For 2010, the current account balance is forecast at 0.5% of GDP, indicating notable improvement from large pre-crisis external imbalances.

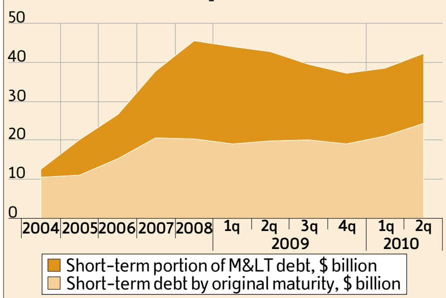
Ukraine's Foreign Trade in Goods and Current Account Balance



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

For the fifth consecutive month, the financial account balance was positive, reporting a $0.6 billion surplus in August 2010. The eight-month financial account surplus reached an impressive $5.8 billion. The positive financial account balance in August was mainly the result of higher FDI inflows ($0.7 billion). At the same time, due to larger external debt repayments and increased population demand for foreign currency, the size of the financial account surplus was notably narrower compared to an average of $1.3 billion for the previous four months. In August, private external debt roll-over declined to 86% compared to a 96% ratio for the first seven months of 2010. The decline in debt rollover ratio was principally due to larger repayments in August and is likely to improve in September following several successful Eurobond placements by the Ukrainian banks and government. Despite large surpluses on the financial account this year, Ukraine should continue maintaining a high degree of confidence among foreign investors as Ukraine's external debt financing needs remain significant. According to NBU data, total external debt due within the next 12 months amounted to $42 billion as of June 2010. With available IMF financing, external debt financing needs are forecast to be successfully covered, while consistent progress in implementation of the economic policy program should restore external sustainability of Ukraine.

Ukraine's Gross External Debt Due Withing Next 12 Months, end of period



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