November 2010

Olga Pogarska, Edilberto L. Segura

- **In October 2010, industrial production grew by 10.2% yoy.**
- **In 2010, Ukraine is estimated to have the sixth largest harvest in 20 years.**
- **The full-year budget revenue target will likely be missed in 2010. However, a budget deficit target of 6.5% of GDP could be achieved thanks to under-execution of non-social expenditures.**
- **The new Tax Code of Ukraine was approved in November.**
- **Consumer inflation decelerated to 10.2% yoy in October.**
- **October monetary data showed further strengthening of credit activity.**
- **Due to notable moderation of export growth amid robust imports in October, Ukraine's ten-month current account balance worsened to $1.8 billion. The full-year current account deficit forecast for 2010 was revised downwards to 2% of GDP.**

Executive Summary

In October, the Ukrainian economy made steady gains despite a weaker external environment and less favorable statistical base effect. Instead, good economic results in industry, construction and services were achieved due to strengthening domestic demand. Thus, while output growth in export-linked metallurgy and machine-building decelerated in October, retail trade and construction benefited from steady growth in real wages, reviving bank credit and better budget financing of infrastructure projects. In addition, Ukraine is forecast to harvest 39.6 million tons of grain in 2010, the sixth largest crop in 20 years.

Budget revenue collections kept strengthening in October. However, available ten-month budget revenue statistics show the annual target is likely to be under-fulfilled. To keep the general budget deficit below 6.5% of GDP, the level committed to with the IMF, the government is keeping non-social expenditures down. Amid growing social spending pressure on the budget and rapid expansion of public debt, Ukrainian authorities (with the assistance of the IMF) started to implement a number of structural reforms. Thus, in November 2010, the new Tax Code of Ukraine was approved, envisaging gradual reduction of major taxes, which should reduce the shadow economy and spur investments. The approval of the Code should accelerate the adoption of the 2011 state budget law, a critical requirement for Ukraine to receive December's IMF tranche.

Consumer inflation decelerated to 10.1% yoy in October as the food price growth lost momentum compared to previous months. The deceleration in inflation allows the NBU to keep monetary policy loose, particularly taking into account that monetary policy easing during summer (the NBU reduced its discount rate three times in three months by a total of 2.5 percentage points) started to bring results. In October, the stock of commercial bank loans to the economy of Ukraine grew by 0.4% yoy. At the same time, the revival of credit activity apparently contributed to worsening current account performance.

In October, imports kept growing at a strong 41% yoy amid high energy, machinery and transport vehicles imports. As the same time, less benign external conditions led export growth to moderate to 14.3% yoy. As a result, the current account deficit stood at $0.9 billion in October, the same amount as for the first nine months of the year. Hence, we revised our forecast of full-year current account deficit downwards to $3 billion, which would correspond to about 2% of GDP in 2010.

	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	24.5
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	-2.2
Gross external debt, % GDP	45.9	50.6	56.0	56.4	88.6	81.5
Exchange rate, Hryvnia/US Dollar, eop	5.1	5.1	5.1	7.7	7.99	7.9-8.0

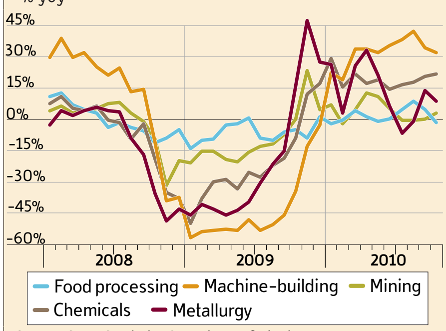
*Projections †Including implicit pension fund deficit ††Including Naftogaz capital injection, implicit pension fund deficit and expenditures covered by IMF's special SDR allocation, excluding bank recapitalization
‡Including Naftogaz, Pension fund deficit (not including bank recapitalization expenditures)
Sources: State Statistics Committee of Ukraine, NBU, Ministry of Finance of Ukraine, 2010 Budget Law, The Bleyzer Foundation

Chief Economist Edilberto L. Segura
Editor Rina Bleyzer O'Malley

Economic Growth

Industrial production growth remained at a strong 10.2% yoy in October, the same rate as in the previous month. However, metallurgy, machine-building and food processing (together accounting for about half of total industrial sales) showed weaker performance. October's solid industrial production growth was achieved thanks to robust overseas demand for Ukraine's fertilizers (the chemical industry reported an almost 22% yoy increase in output that month) and strong domestic demand for energy due to rather cold weather (electricity production was up by 10.6% yoy in October compared to about 3.5% yoy a month before).

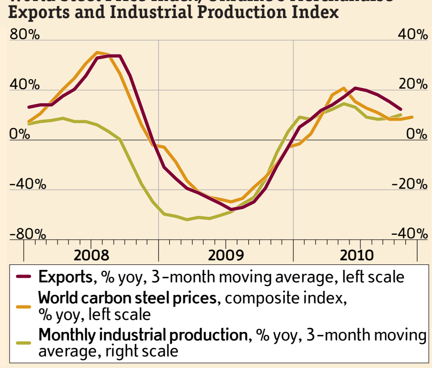
Industrial Production Growth by Select Branches
% yoy



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

At the same time, output growth in metallurgy eased to about 9% yoy in October compared to a 14% yoy increase a month before. While an increased statistical base played a notable role, the deceleration may also be attributed to increased uncertainties about short-term world steel market conditions.[1] Russia's ambitious investment program to renovate its largely worn-out locomotive fleet and rolling stock benefited Ukraine's machine-building industry. However, output growth in the industry slowed to 32% yoy in October (down from 42% yoy in August), which may be linked to ongoing court trials over the sale of Luganskteplovoz (one of the leading heavy machinery producers) to Bryansk Engineering Plant (Russia)[2] as well as a waning low base effect.

World Steel Price Index, Ukraine's Merchandise Exports and Industrial Production Index



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

As of November 26th, Ukraine has harvested 41.4 million tons of grain (unclean output), which caused the Ministry of Agricultural Policy of Ukraine to upgrade its grain harvest forecast (after cleaning) to 39.6 million tons for 2010. Still lower than in 2008-2009, this year's crop will be the sixth-largest in the last 20 years. In addition, Ukraine collected almost 50% yoy and 10% yoy more sugar beets and sunflower seeds. Given also continuing growth in animal production, agriculture kept improving with output decline in the sector easing to 1.2% yoy for January-October.

Ukraine's Real Sector Performance
cumulative change, % yoy

	2010 9m	2010 10m	2009 10m	2008 10m
Agricultural output	-1.3	-1.2	0.1	17.6
Industrial output	10.8	10.7	-26.4	2.2
Construction works	-12.6	-9	-51.5	-9.4
Domestic trade turnover				
Wholesale trade	2.4	2.4	-23.2	-0.9
Retail trade	5.1	5.9	-16.3	20.5
Restaurants	1.8	2.4	-16.6	8.5
Transportation turnover				
Cargo	8.7	8.1	-27.6	3.9
Passenger	-1.9	-1.8	-10.8	5.8

Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Despite a good 2010 harvest, food processing (which is typically closely linked to agricultural performance) shrank by 1.4% yoy in October. Although food processing is a mostly domestic market oriented industry, about 1/3 of its output is exported. Hence, the decline in industrial output may be the result of Russia's introduction of import restrictions on Ukraine's meat, milk and dairy products, and poultry in mid-October. The industry may further suffer in the coming months as Russia announced an imposition of import duties on Ukraine's caramel at the end of November.

Weaker export opportunities constrained the development of wholesale trade and cargo transportation. In contrast, domestic demand kept strengthening in October amid steady growth of real wages and improving investment activity, favoring domestic oriented sectors. Indeed, real wages grew by 10.8% yoy in October, the same rate as in September this year. In addition, recent consumer confidence surveys also revealed cautious optimism among Ukrainian consumers in September-October. Thus, retail sales turnover grew by almost 6% yoy, up from about 5% yoy in the first nine months of the year. Larger budget financing of infrastructure projects and gradually restoring bank credit activity in the second half of the year supported Ukraine's construction sector. According to the State Statistics Committee of Ukraine, the decline in investments into fixed capital moderated to 2.9% yoy over January-September (from 7.4% yoy in 1H 2010), suggesting encouraging growth in 3Q 2010. Correspondingly, the rate of contraction in the value of construction work done in Ukraine diminished to 9% yoy for January-October.

[1] While world steel prices are still facing continuing pressure from the rising cost of raw materials (iron ore, coking coal, etc.), the world demand for steel may weaken in the coming months as construction activity typically slows during the winter months. In addition, already announced or still looming policy tightening in a number of countries (mainly the EU and China) as well as renewed euro-zone sovereign-debt anxiety weigh on global economic growth prospects, and the steel market in particular.

[2] Luganskteplovoz is one of the leading heavy machinery producers, specializing in mainline locomotives, diesel and electric trains, transporters, and units for suburban trains. In June 2010, a 76% stake of the company was sold to Bryansk Engineering Plant (Russia) in a privatization auction. The tender results were challenged in court by Mantara Holding (Cyprus), which was not allowed to participate in the auction. At the end of October, the court ruled to cancel the deal. In turn, Bryansk Engineering plant has appealed the court ruling.

Given a particularly strong base effect in November-December and external market uncertainties, we have kept our real GDP growth forecast for 2010 unchanged at about 4% yoy. At the same time, solid growth in industrial production over the first ten months of the year (up by 10.7% yoy), revival of investment activity and consumer optimism in recent months indicate there are risks on the upside to the forecast.

Fiscal Policy

According to the State Treasury of Ukraine, state budget revenue collections (excluding VAT refunds through the government issuance of VAT bonds, budget institutions' revenues and transfers from local budgets) rose by a nominal 25.4% in January-October over the same period last year, up from a 25% yoy increase reported for the first nine months of 2010. However, adjusting for the sizable settlement of VAT refund arrears during August-September (both in cash and VAT bonds issuance) and likely in October, the pace of state budget revenue increase was unacceptably low (only 9.2% yoy for January-September 2010) compared with the vigorous expenditure growth. The latter reached 26% yoy for the first nine months of the year. As a result, the nine-month state budget deficit virtually reached the annual target.

Selected Changes to Ukraine's Tax System

	Current rate	Enforcement Date				
		1/1/2011	1/1/2012	1/1/2013	1/1/2014	1/1/2015
VAT	20%				17%	
Corporate profit tax	25%	23%*	21%	19%	16%	
Personal income tax	15%	**15%** on income below 10 minimum wages, set as of the beginning of the year, **17%** on income exceeding that level				
Tax on deposit interest payments						5%
Property tax			**0**, if total apartment (house) area does not exceed 120 sq. m (250 sq. m) **1%** of minimum wage as of the begging of the year, if total apartment (house) area ranges from 120 sq. m (250 sq. m) to 240 sq. m (500 sq. m) **2.7%** of minimum wage as of the begging of the year, if total apartment (house) area exceeds 240 sq. m (500 sq. m)			

*Enforced on April 1st, 2011
Source: Tax Code of Ukraine, The Bleyzer Foundation

Although Ukrainian authorities have been quite conservative with state budget data since September, the available statistics suggest that the fulfillment of the state budget revenue target will be a challenging task. According to 2010 state budget law, state budget revenues are targeted at UAH 252.8 billion ($31.8 billion). The State Treasury data on revenue collections for the first ten months of the year indicate that during November-December, the government should accumulate more than a quarter of the annual revenue target. Even with aggressive tightening of tax administration measures during these months, the task looks unrealistic as average monthly revenue collections to the state budget in November-December would virtually double the average amount raised during the first ten months of the year.

Likely budget revenue shortfalls will require additional expenditure-driven fiscal adjustment to keep the general budget deficit (including Pension Fund and Naftogaz imbalances) at 6.5% of GDP, which is one of the main IMF requirements. As expenditure cuts are politically difficult to implement officially (through amending the state budget law), government authorities will continue to under-fulfill non-social expenditures. According to the Accounting Chamber of Ukraine, expenditures from the general fund of the state budget were almost 3% below target for January-September, mainly on account of lower financing of government economic projects. Scaling down on budget financing of non-social projects, however, can only be a temporary solution as social expenditures account for the lion's share of total budget expenditures and represent a growing spending pressure on the budget. In 2009, pension expenditures amounted to about 18% of GDP, one of the highest levels in the world. Over the first nine months of the year, social protection expenditures grew by an impressive 49% yoy amid a 51% yoy increase in transfers to the pension fund of Ukraine, according to the Accounting Chamber report. To restore sustainability of public finances, the Ukrainian authorities (with IMF assistance) have started implementing long-awaited structural reforms.

The government announced a number of pension and administrative reform measures. Authorities plan to gradually raise the pension age for both men and women starting next year and reduce the maximum pension cap. As part of the administrative reform, several government agencies will either be cut or reorganized to reduce the number of employees. Ukraine's low tax system rankings in the World Bank's annual surveys (according to the latest "Doing Business", Ukraine's tax system was ranked the third worst out of 183 countries) and the need to sustain public finances underpinned the need for comprehensive tax reform. In mid-November 2010, the new Tax Code of Ukraine was adopted by parliament. The Code envisages a number of tax rate cuts for businesses and contains efforts to broaden the tax base by reducing the shadow economy. In particular, corporate profit tax and value added rates will be gradually reduced from the current 25% and 20% to 16% and 17%, respectively, by 2014. At the same time, personal income will be taxed by 15-17%.

Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: +1 (713) 621-3111 Fax: +1 (713) 621-4666
E-mail: sbleyzer@sigmableyzer.com

Kyiv Office, Ukraine
4A, Baseyna Street, "Mandarin Plaza", 8th floor
Kyiv 01004, Ukraine
Tel: +38 (044) 284-1289 Fax: +38 (044) 284-1283
E-mail: kiev.office@sigmableyzer.com.ua

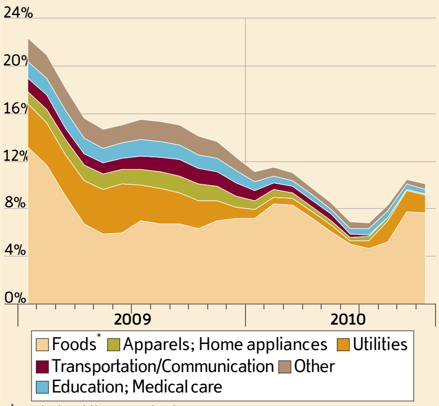
Kharkiv Office, Ukraine
Meytin House, 49 Sumska Street, Office 4
Kharkiv 61022, Ukraine
Tel: +38 (057) 714-1180 Fax: +38 (057) 714-1188
E-mail: kharkov.office@sigmableyzer.com.ua

To compensate for the revenue shortfalls, the government introduced new taxes on property, deposits, dividends, and other interest revenues, and further raised excises on gasoline products (by about 40%), alcohol and tobacco (up by about 7%). To secure sufficient revenues, the government also intends to reduce the shadow economy by reforming the simplified taxation system and tightening tax administration. The system allows for generous tax breaks for self-employed workers but provides ample opportunities for tax evasion. Initially, the government planned to virtually abolish the system, substantially narrowing criteria to qualify for the system. In addition, the new tax code granted extra power to tax authorities, including the right to confiscate taxpayer's assets without a court decision, violating the basic presumption of innocence principle. As the approved tax code caused a new wave of critique from the business community and sparked two weeks of street rallies of self-employed workers in late November, the President vetoed the code and returned it to the parliament with the proposals to correct for the above-mentioned deficiencies and to restore the simplified taxation system. On December 2nd, the parliament amended the tax code to incorporate the President's suggestions. While retention of the simplified taxation is in contrast with IMF requirements, compromise may be found as the government is going to refine the respective legislation during the first half of 2011. So far, the approval of the 2011 budget law is seen as the most crucial IMF requirement for Ukraine to receive December's tranche of about $1.5 billion. The final adoption of the code should relaunch the 2011 budget process.

Monetary Policy

After a two-month rally, consumer price growth pulled back in October, advancing by a surprisingly moderate 0.5% month-over-month (mom). In annual terms, price growth eased to 10.1%, down from 10.5% a month before. While food, hard liquor and tobacco indices posted the largest increases in October, they lost momentum compared to previous months. The food index reported a moderate 0.5% mom growth in October, as ongoing increases in prices for meat, bread and bakery, milk and dairy products were partially offset by falling prices for sugar (thanks to the plentiful sugar beet harvest), eggs, fruit and vegetables.

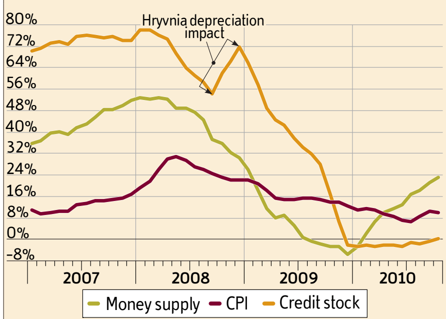
Annual Consumer Price Index Growth by Main Components, percentage points



*Foods, hard liquor and tobacco
Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Unusual for October, fruit and vegetables deflation may be attributed to downward correction from the over-reaction during August-September to the poor harvest. At the same time, lower food inflation may also be attributed to local authorities' regular practices of organizing special agricultural fairs in large cities of Ukraine during October (in the run-up to local elections). Such fairs can be considered as indirect administrative price controls as food prices there are about 10-15% below market ones. Moreover, a reduction (as in case of landline phone services) or a suspension in increases (heating and other utilities) in several administratively regulated tariffs also helped to keep consumer However, given the temporary nature of most of October's developments, price growth is expected to accelerate through the end of the year, although the chances of keeping year-end inflation close to 10% have notably increased recently.

Select Monetary Indicators
% yoy



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

In October, the growth of monetary aggregates accelerated to about 23% yoy, up from 18% yoy (narrow money) and 21% yoy (money supply) a month before. The acceleration came in spite of net sales of $0.5 billion of NBU reserves to support the Hryvnia exchange rate and further NBU measures to absorb excess liquidity from the market (though the volume of the latter was notably lower in October compared to the previous three months), and some tightening of reserve requirements.[3] Similar to previous months, faster growth of money supply stemmed mainly from strong growth in deposits, which advanced by more than 26% yoy in October despite declining deposit rates. Interestingly, while the growth of households' deposits is apparently losing steam, corporate deposits have been gaining momentum, which signals the improving financial stance of the Ukrainian corporate sector. As short-term correlation between money supply growth and consumer price inflation could be rather weak, particularly taking into account the slow recovery of money demand. At the same time, sustainably high growth in money supply could lead to faster future inflation and impede central bank efforts to combat it. However, with current limited impact on inflation, the NBU is more concerned about Hryvnia exchange rate stability and stimulating growth.

[3] Starting October 1st 2010, the NBU reinstituted a 20% reserve requirement for commercial banks' short-term (less than 183 days) foreign currency borrowings from abroad. The respective requirement was suspended in December 2008 when the financial crisis was in full swing in Ukraine.

Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: +1 (713) 621-3111 Fax: +1 (713) 621-4666
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Kyiv Office, Ukraine
4A, Baseyna Street, "Mandarin Plaza", 8th floor
Kyiv 01004, Ukraine
Tel: +38 (044) 284-1289 Fax: +38 (044) 284-1283
E-mail: kiev.office@sigmableyzer.com.ua

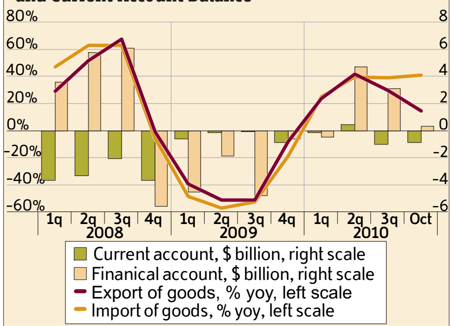
Kharkiv Office, Ukraine
Meytin House, 49 Sumska Street, Office 4
Kharkiv 61022, Ukraine
Tel: +38 (057) 714-1180 Fax: +38 (057) 714-1188
E-mail: kharkov.office@sigmableyzer.com.ua

The NBU commitment to a nominal exchange rate anchor may be explained by deeply rooted association by the Ukrainian population of a stable exchange rate with overall macroeconomic stability in the country. In addition, greater volatility of the exchange rate amid the high external indebtedness of the country, with short-term external debt financing needs exceeding its growth international reserves,[4] may further increase the external debt burden for the country. Summer monetary policy easing (the NBU reduced its discount rate three times in three months by a total of 2.5 percentage points) started to bring results. In October, the stock of commercial bank loans to the economy of Ukraine grew by 0.4% yoy, supporting the revival of the Ukrainian economy. Despite the above considerations, the NBU declared inflation targeting as its ultimate goal. As exchange rate and price stability are often incompatible monetary policy goals, the NBU is likely to start gradually liberalizing its foreign exchange rate regime, as this is also required in the IMF program.

International Trade and Capital

Due to less benign external conditions for Ukraine's metallurgy, grain export restrictions and Russia's weaker demand for Ukrainian heavy machinery, export of goods reported rather moderate growth of about 14% yoy in October, notably down from about 30% yoy growth on average during the first nine months of the year. Unlike exports, imports kept growing at a fast pace, advancing by a strong 41% yoy in October. In addition to soaring imports of fossil fuels (up by 58% yoy in October), high rates of growth were also reported for imports of machinery and transport vehicles (up by 40% yoy) and metallurgical products (up by almost 61% yoy). Acceleration of non-energy imports observed since mid-2010, although partially explained by a low statistical base effect, may be attributed to a stronger increase in domestic demand amid steady growth of real wages, better budget financing of infrastructure projects and reviving credit activity.

Ukraine's Foreign Trade in Goods and Current Account Balance



Source: NBU, The Bleyzer Foundation

As the rise in imports notably outpaced exports, a worsening merchandise trade balance led to faster than expected widening of Ukraine's current account deficit. Just in October, the current account deficit stood at $0.9 billion, virtually the same amount reported for the third quarter of 2010. The cumulative CA gap reached $1.8 billion for the first ten months of the year. Observing a larger-than-expected widening of the CA balance in October and given that imports typically grow fast in the last months of the year while export prospects remain uncertain, we have revised our forecast of full-year current account deficit downwards to $3 billion, which would correspond to about 2% of GDP in 2010.

Simultaneously, with a worsening current account balance, the surplus on the financial account of the balance of payments notably narrowed in October to $0.3 billion (during the second and third quarters of 2010, monthly surpluses on the financial account averaged $1.3 billion). October's smaller surplus was mainly the result of commercial banks' higher external debt repayments (mainly short-term) and strong population demand for cash foreign exchange. As the financial account surplus only partially covered the current account deficit in October, the shortage was financed through the reduction in international reserves to $34.3 billion as of end-October. At the same time, the current level of NBU gross international reserves and high external debt roll-over (although the banking sector external debt rollover ratio declined to 79% in October, it stood at a high 87% for January-October; in addition, the respective ratio for corporate sector external debt grew to strong 124% for January-October) suggest the country remains well-cushioned against adverse shocks. Hence, the Hryvnia exchange rate is likely to remain in the range of UAH 7.95-8.0 per USD through the end of the year.

[4] As of end-June 2010, Ukraine's gross external debt stood at $104.5 billion and is forecast to account for about 78% of GDP in 2010. Moreover, according to NBU external debt data based on residual maturity, external debt financing needs from June 2010 to May 2011 amounted to $42 billion, while the NBU gross international reserves stood at $34 billion as of end-June 2010.

Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: +1 (713) 621-3111 Fax: +1 (713) 621-4666
E-mail: sbleyzer@sigmableyzer.com

Kyiv Office, Ukraine
4A, Baseyna Street, "Mandarin Plaza", 8th floor
Kyiv 01004, Ukraine
Tel: +38 (044) 284-1289 Fax: +38 (044) 284-1283
E-mail: kiev.office@sigmableyzer.com.ua

Kharkiv Office, Ukraine
Meytin House, 49 Sumska Street, Office 4
Kharkiv 61022, Ukraine
Tel: +38 (057) 714-1180 Fax: +38 (057) 714-1188
E-mail: kharkov.office@sigmableyzer.com.ua