Ukraine
Macroeconomic Situation

December 2010

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- **The Ukrainian economy is forecast to grow by about 4% yoy in 2010 and 4.5% yoy in 2011.**
- **The government presented a Draft 2011 Budget Law targeting a 3.08% of GDP deficit in 2011.**
- **On December 9th, the first stage of public administration reform was officially launched.**
- **In November 2010, annual inflation moderated to 9.2% yoy. Consumer prices are forecast to increase by 10% yoy in 2010 and 2011.**
- **The current account deficit is projected to widen to about 3% of GDP on strong investment demand in 2011, but will be securely covered with FDI inflow.**

Executive Summary

In 2010, the Ukrainian economy is expected to grow by about 4% yoy. In the first half of the year, the recovery was mainly export-led. In the second half of the year, as the external environment worsened, the growth was supported by restoring private consumption and investment demand. In 2011, real GDP is forecast to slightly accelerate to 4.5% yoy amid vigorous investment demand. The latter, however, will also spur imports. The current account, thus, is projected to further widen to about 3% of GDP in 2011, with net exports dragging down the pace of economic growth. Due to slower transfer of higher natural gas prices to other utility tariffs and administrative measures to suppress food price growth, inflation will be kept around 10% in 2010. However, as utility price growth is set to resume strongly next year, we have kept the 2011 inflation forecast at 10%.

At the beginning of December, soon after the approval of the new Tax Code, the government presented the Draft 2011 Budget Law. Due to new taxation rules with lower corporate taxes and some new tax breaks, the draft envisages a moderate increase in budget revenues, up by a nominal 11.4% yoy. At the same time, to reduce the deficit, expenditures are projected to increase by about 4%. Expenditure tightening allowed the government to target the state budget deficit at 3.08% of GDP in 2011. Approval of the 2011 budget law with a general government deficit below 3.5% of GDP in 2011 is one of the key IMF requirements for Ukraine to receive December's IMF tranche. To reduce budget expenditures, Ukrainian authorities launched public administration reform at the beginning of December 2010 and plan to reveal the details of pension reform by the end of the year.

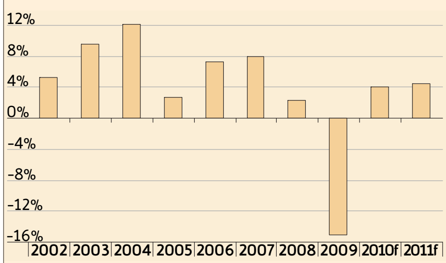
	2006	2007	2008	2009	2010*	2011*
GDP growth, % yoy	7.3	7.9	2.1	-15.1	4.0	4.5
GDP per capita, $	2 300	3 070	3 870	2 540	2 950	3 420
Industrial production, % yoy	6.2	10.2	-3.1	-21.9		
Retail sales, % yoy	24.8	28.8	18.6	-16.6		
Budget deficit, % GDP	-0.7	-1.5†	-2.1†	-8.5	-6.5††	-3.5
Government external debt, % GDP	11.0	8.7	9.3	20.5	24.5	30.0
Inflation, eop	11.6	16.6	16.6	12.3	10.0	10.0
Gross international reserves, $ billion	22.4	32.5	31.5	26.5	34.0	35.0
Current account balance, % GDP	-1.5	-3.7	-7.0	-1.7	-2.2	-3.0
Gross external debt, % GDP	50.6	56.0	56.4	88.6	81.5	75.0
Exchange rate, Hryvnia/US Dollar, eop	5.1	5.1	7.7	7.99	7.9-8.0	8.0

*Projections
†Including pension fund deficit
††Including Naftogaz, pension fund deficit ; excluding bank recapitalization expenditures
Sources: State Statistics Committee of Ukraine, NBU, Ministry of Finance of Ukraine, 2010 Budget Law, Draft 2011 Budget Law, The Bleyzer Foundation

Economic Growth

In 2010, the Ukrainian economy continued to recover from the deep recession of the previous year, when GDP fell by a real 15.1% yoy. In the first half of the year, the recovery was mainly export driven, while domestic demand remained weak. Industrial production and wholesale trade and cargo transportation (which are closely linked to it) benefited from stronger revival of the world economy and trade, and thus world commodity prices, as well as improved relations with Russia, the main export market for Ukraine's machinery. Since the second quarter, domestic consumption has been steadily rising, prompted by large social spending from the budget as well as increased consumer confidence amid the improving macroeconomic situation and political stability. At the same time, investments into fixed capital started to recover only in the second half of the year, supported by better budget financing of infrastructure projects and restoring bank credit. Unlike domestic demand, the external environment worsened in the second half of the year as escalation of the eurozone sovereign debt crisis and announced policy tightening in a number of leading countries raised concerns over the pace of the global recovery and the development of world commodity prices. As a result, real GDP growth decelerated from about 5.5% yoy in 1H 2010 to 3.5% yoy in the third quarter of the year. Due to a strong statistical base effect, real GDP growth is likely to further decelerate. At the same time, due to higher than expected GDP growth in the first half of 2010 and strong real sector growth in October, our full-year economic growth forecast at about 4% yoy may be slightly conservative.

Real GDP Growth
% yoy



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Looking into 2011, the Ukrainian economy is forecast to expand by 4.5% yoy. With a generally positive outlook for global recovery and predicted stronger growth in Ukraine's main trading partner countries, exports are projected to rise robustly next year. The growth will also be supported by buoyant investment activity. Higher investments will be triggered by infrastructure development related to the Euro 2012 football championship and more substantial improvement in bank credit availability. At the same time, consumer spending is likely to grow moderately as, according to the 2011 draft state budget law, real average monthly wage growth is to decelerate to 4% yoy (down from almost 10% yoy for the first ten months of 2010). In addition, in 2011 unemployment in Ukraine is likely to be higher due to the public administration reform launched in mid-December. According to government officials, the number of central government employees is to be reduced by about 50%, while the number of general government workers will be reduced by about 30%. Furthermore, stronger investments and solid economic activity will stimulate imports, exacting a toll on economic growth in 2011. That is why real GDP growth is projected to accelerate rather moderately in 2011 compared to this year.

Fiscal Policy

Following the final adoption of the new Tax Code at the beginning of December 2010, the government quickly approved the draft of the 2011 state budget law and submitted it to the parliament. Ukraine should adopt the budget law in late December and receive December's IMF tranche in the amount of $1.5 billion. In 2011, the government is targeting a state budget deficit at 3.08% of GDP, which implies a general budget deficit at about 3.5% of GDP, fully in compliance with IMF requirements. The government projects real GDP and prices to grow by 4.5% yoy and 8.9% yoy, respectively. Although

Main State Budget Indicators in 2010-2011

	2010F		2011F		10m 2010		
	UAH billion	% yoy	UAH billion	% yoy	UAH billion	% yoy	Execution rate, %
Total Revenues	**252.8**	**20.5%**	**281.5**	**11.4%**	**184.4**	**11.1%**	**73.0%**
Tax revenues	188.2	26.4%	234.6	24.6%**	126.8	10.1%	67.4%
EPT	40.0	22.8%	44.3	10.8%	29.1	13.4%	72.7%
VAT	104.7	23.8%	108.3	3.4%	65.0	1.5%	62.1%
Excises	29.7	39.5%	41.1	38.3%	22.6	38.3%	76.0%
Non-tax revenues	55.4	9.3%	42.7	-22.9%**	50.7	16.6%	91.6%
Total Expenditures*	**306.8**	**9.3%**	**320.3**	**4.4%**	**240.7**	**25.5%**	**78.7%**
Budget deficit (% of GDP)	**54.1**	**5.0%**	**38.8**	**3.1%**	**56.3**		**104.0%**
Deficit financing							
Net domestic borrowing	56.5		11.1		43.3		76.6%
Net external borrowing	27.3		18.3		38.1		139.2%
Privatization receipts	6.4		10.0		0.5		8.6%

*Including net credit from the budget
**The notable rise in tax revenues and the decline in non-tax collections are explained by a transfer of rent payments into tax proceeds in the 2011 Budget, in accordance with the Budget Code, approved in July of this year
Source: 2010 Budget Law, the draft 2011 Budget Law, Government Report on State Budget Execution for January-October, 2010, The Bleyzer Foundation

the inflation target may be slightly underestimated, the overall macroeconomic assumptions used to develop the draft budget law look realistic.

The state budget revenues are forecast at UAH 282 billion ($35 billion), up by a nominal 11.4% yoy. The rather moderate increase is explained by the fact that next year's budget was designed based on the new tax rules, envisaging reduction in the corporate profit tax rate from the current 25% to 23%, elimination of several taxes and duties, and introduction of tax breaks (e.g., 0% corporate profit tax for enterprises with annual turnover less than UAH 3 million, 0% VAT rate for selected agricultural and wood products). While the revenue shortfalls from the above changes will be compensated for by higher excises and introduction of new taxes (on deposits, dividends and other interest, on property, etc.), the economy may require some time to adjust to changes in tax legislation. At the same time, budget revenues in 2011 may still fall short of the target due to possible budget revenue under-execution in 2010. For January-October 2010, budget revenues stood at UAH 184 billion, only 73% of the annual target. While available data showed notable improvement in revenue collections in November, successful execution of budget revenues in December looks challenging.[1]

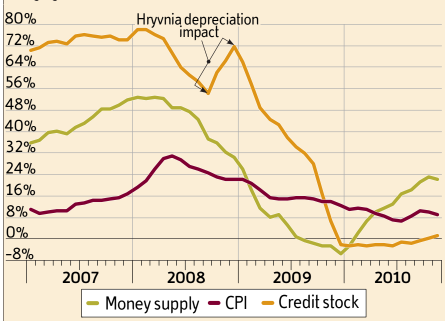
To keep the general government deficit below 3.5% of GDP in 2011, the government will tighten expenditures, which will grow by a modest 4.4% yoy in nominal terms. Public administration and pension reform measures are among the main government efforts to hold down budget spending growth. While details of pension reform are still developing, some measures have already been announced. The pension age for women will gradually be raised from the current 55 to 60 years by 6 months every half a year. The government is also considering the possibility of increasing the pension age for men. Although according to the Ministry of Labor and Social Policy, life expectancy for men at 60 years is 14 years, an increase in the pension age for men is controversial because men's life expectancy at birth is only 62 years. Introduction of a cap on retirement benefits (at 12 living wages) will also be among the measures that would help reduce the Pension Fund deficit to UAH 17.8 billion in 2011, down from UAH 26.6 billion in 2010. Thus, total Pension fund transactions from the state budget will be reduced by UAH 6.5 billion to UAH 58.3 billion in 2010.[2]

On December 9th public administration reform was officially launched. In the first stage, the number of central executive bodies was reduced from 112 to 63. Thus, the number of ministries declined from 20 to 16 to eliminate duplication of functions and coordination problems. There are now 17 members of the Cabinet of Ministers versus the previous 26. A number of State Committees were subordinated to a particular ministry, which may mean that over time they will be integrated into the ministries to avoid overlapping of functions. As a result of the above measures, the staff of the general government and the Cabinet of is projected to be reduced by 30% and 50%, respectively. This reorganization is an important step towards making the government more effective. However, more actions are still necessary to improve public governance in Ukraine, including reforms of the local governments and strong anti-corruption measures.

Monetary Policy

Following surprisingly low monthly inflation in October, November's consumer price growth was again lower than expected, advancing by a meager 0.3% month-over-month (mom), a record low for this month. As a result, in annual terms inflation slowed to 9.2% in November from 10.1% a month before. The deceleration was due to the unusual for November reduction in prices on fruits and vegetables (down by 2.6% mom and 1.4% mom, respectively) and slow transmission of higher natural gas prices on other utility tariffs (the cost of hot water and heating have increased by only 2% since August 2010, when natural gas tariffs for heating companies were raised by 50%). Given the notable deceleration in price growth in October-November, year-end inflation will be around 10% in 2010, much lower than the officially targeted 13.1%.[3]

Select Monetary Indicators
% yoy



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

According to the Draft 2011 Budget Law, end-of-period consumer inflation is projected at 8.9% next year. At the same time, we forecast consumer prices to grow by about 10% in 2011 mainly on account of faster adjustment of utility tariffs (hot water and heating, electricity, etc.), the growth of which was administratively suppressed since August of this year. In addition, the impact of money sup-

[1] According to the State Treasury of Ukraine, state budget revenues amounted to UAH 215 billion ($27 billion). This means that in November the government collected UAH 30.6 billion, almost twice as much as the average monthly amount collected for the first ten months of the year. Given scarce information on the sources of such improvement, it is unclear whether the target of about UAH 36 billion for December is attainable.

[2] Source: Pension Fund budget for 2010 approved by the Cabinet of Ministers on July 21st, 2010. Draft of the Pension Fund budget for 2011, presented in a package of documents related to the Draft 2011 Budget Law.

[3] Source: Cabinet of Ministers Decree #281 as of March 24th, 2010.

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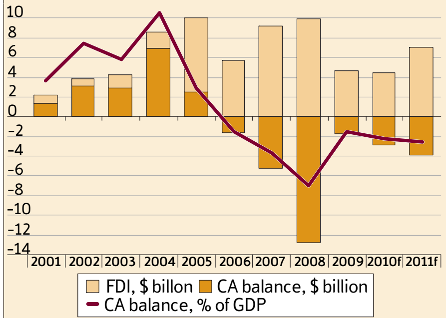
ply growth on consumer price inflation was rather weak in 2010. However, with forecasted stronger recovery of money demand and better credit availability, consumer prices may face higher pressure from buoyant money supply growth, as monetary policy is forecast to remain generally unchanged in 2011.

In November, monetary aggregates grew by 19% yoy (narrow money) and 22% (money supply). In monthly terms, the monetary base declined by almost 3% in November. In addition to net NBU sales of foreign currency reserves (about $0.4 million) to support the Hryvnia exchange rate, the decline was the result of a 22% mom reduction in cash balances on commercial banks' correspondent accounts. The latter may be attributed to an increase in commercial banks' reserves held on separate NBU accounts, higher banks' interest in domestic securities (in November, the government issued UAH 7.4 billion T-bills to increase Naftogaz capital), and advance repayments of NBU refinancing credits.[4] The decline in money supply was mainly the result of a lower monetary base and stalled deposit growth. In November, household deposits kept growing, though at a slower pace (1% mom versus 1.7% mom in October). However, the outflow of corporate deposits (-2% mom)[5] caused the total stock of deposits to remain virtually unchanged. At the same time, as bank credit kept increasing, money supply fell by a meager 0.2% mom in November. As the stance of the monetary policy did not change, November's development of monetary aggregates is likely to be a temporary phenomenon.

The NBU continued to maintain nominal exchange rate stability during November-December through regular interventions on the interbank forex market. At the same time, the NBU committed to the IMF to gradually liberalize its foreign exchange rate regime, and allowed slightly wider Hryvnia exchange rate volatility. As this move was accompanied by an increase in foreign currency demand, officially the Hryvnia slightly depreciated from about UAH 7.92 per USD at the beginning of November to UAH 7.95 per USD in mid-December. Due to net NBU sales of foreign exchange and foreign currency valuation losses (which reflected Euro depreciation against the US Dollar), Ukraine's gross international reserves declined to $33.5 billion as of November. This level, covering about 5 months of Ukraine's import of goods and services, is sufficient to keep the Hryvnia exchange rate in the range of UAH 7.95-8.0 per USD through the end of the year.

International Trade and Capital

Due to acceleration of imports and slower growth in exports, during the second half of 2010, Ukraine's current account deficit was widening faster than we expected. The growth in imports (39% yoy on average over January-October compared to an average of 32% yoy for 1H 2010) was underpinned by higher energy imports and faster recovery of consumer and investment demand. At the same time, due to a less favorable external environment and introduction of grain export restrictions, the growth of exports slowed from 33% yoy on average for 1H 2010, to 26% yoy for January-October.



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Although world economic growth is projected to lose momentum, this will occur mainly on account of mature economies, while emerging markets will continue to grow at a robust pace. Next year's prospects for Ukraine's foreign trade are generally positive. But as imports are also set to accelerate amid a pick-up in investment demand, the current account is forecast to worsen to about 3.0% of GDP in 2011. Although it may widen, the 2011 current account deficit will remain much lower than pre-crisis levels and is forecast to be more than covered by FDI inflow to the country. Given the high external private debt roll-over ratio in 2010 (102% for the first ten months of 2010) and improving macroeconomic situation, Ukraine is likely to maintain a high ratio in 2011 as well. This implies that the financial account will remain in surplus next year. As the NBU will continue to target exchange rate stability, the Hryvnia exchange rate is projected to stay at around UAH 8.0 per USD in 2011.

[4] According to anecdotal evidence, in mid-November the NBU sent a telegram to banks that received NBU refinancing during in 2008-2009, asking them to consider advance repayment of the refinancing credit.

[5] The decline in corporate deposits may be a seasonal factor as during November-December, many companies fulfill their obligations on import contracts and make advance payments. Uncertainty related to the approval of the new tax code may have also played a role.

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