SigmaBleyzer

Ukraine
Macroeconomic Situation

THE BLEYZER FOUNDATION
Turning Transitions Into Prosperity

April 2012

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- **Real GDP growth slowed to 1.8% yoy in 1Q 2012, according to advanced estimates.**
- **In March 2012, industrial production declined by 1.1% yoy, reflecting weaker exports and investments.**
- **Agriculture will remain an important driver of growth in 2012. As fears over the winter crop outlook related to severe frosts did not materialize, the official 2012 grain harvest forecast was improved to 45-50 million tons.**
- **Above-target state budget revenue growth for 1Q 2012 led the government to amend the state budget law to increase social spending. However, the full-year deficit target was left unchanged at 1.7% of GDP.**
- **Consumer inflation eased to 1.9% yoy in March, an almost decade low level. However, easing inflation pressures and improved banking liquidity has a limited impact on commercial banks' lending activity.**
- **In March, despite weaker exports, Ukraine's current account balance improved as the decline in imports outpaced exports.**
- **A positive Balance of Payments in March allowed the NBU to keep the Hryvnia exchange rate virtually stable over the months, and also to slightly augment its gross international reserves.**

Executive Summary

The Ukrainian economy grew slower in March 2012 as, in addition to a challenging external environment, some of the domestic factors lost their intensity that month. A 2.5% yoy decrease in exports of goods in March, led by weak exports of metallurgical and mineral products as well as a sharp slowdown in overseas shipment of machinery and transport vehicles, weighed on economic activity in the respective industries, cargo transportation and wholesale trade. Thus, industrial output fell by 1.1% yoy in March, while cargo turnover was down by almost 8% yoy in 1Q 2012. In addition, the real value of construction works fell by 2.7% yoy in 1Q 2012 amid the completion of large infrastructure projects related to the Euro 2012 football championship. As the impact of adverse weather conditions of the last two winter months subsided, so also did demand for energy resources. Thus, production of electricity, with growth of 12.3% yoy in February, contributed strongly to industrial sector performance that month, but was only 0.1% yoy higher in March 2012.

On the upside, however, economic growth was supported by strong domestic consumption. Underpinned by a 14.7% yoy increase in real wages, retail sales turnover rose by 14.2% yoy in 1Q 2012. Furthermore, fears that severe frosts during January-February could further damage winter agricultural crops did not materialize. As a result, agricultural output growth slightly accelerated to 0.7% yoy in March, while the official 2012 grain harvest forecast was improved to 45-50 million tons. Overall, however, according to provisional estimates, real GDP growth slowed to 1.8% yoy in 1Q 2012, which is in line with our full-year forecast of about 3% yoy in 2012.

Despite weaker exports, Ukraine's balance of payments kept improving in March. The current account deficit narrowed to $0.3 billion in March as the decline in imports outpaced exports. Furthermore, thanks to lower population demand for foreign currency and solid foreign trade credit inflows, the financial account surplus more than covered the current account gap. As a result, the Hryvnia exchange rate remained virtually stable over the month, while the National bank of Ukraine slightly augmented its gross international reserves to $31.1 billion at the end of March.

For 1Q 2012, the state budget stayed in surplus thanks to stronger than expected budget revenue growth. State budget proceeds grew by a nominal 16.3% yoy in 1Q 2012 compared to a full-year target of 5.8% yoy. Above-target revenue growth, achieved mainly due to tighter administration of taxes, led the government to amend Ukraine's state budget law to increase social expenditures. However, as the revenue plan was amended to fully cover expenditure increases, the state budget deficit target was left unchanged at 1.7% of GDP. Correspondingly, we kept our full-year consolidated public sector deficit forecast (including Naftogaz and pension fund deficits) at about 3.5% of GDP in 2012.

On the inflation front, Ukraine kept benefiting from a favorable base effect and low food price growth. Consumer inflation eased to 1.9% yoy in March, one of the lowest levels in the region. Given the considerable progress in reducing inflation in 1Q 2012, our year-end inflation forecast was revised downwards to 7-8% yoy in 2012.

Despite better than projected performance in 1Q 2012, the Ukrainian economy remains fragile. The health of the external sector and sustainability of public finances are the main macroeconomic challenges for Ukraine. Thus, high external financing needs may generate depreciation pressures during the year. Due to announced fiscal loosening, with most spending increases being recurrent, fiscal consolidation will proceed slower than projected. Although public debt in terms of GDP is not large by international standards (37% of GDP in 2011), high debt service payments narrow the government's room to maneuver in case of adverse developments. Furthermore, high public debt service needs amid turbulent international financial markets have increased the government reliance on domestic debt securities. To attract sufficient funds, the government accepts rather high yields on short maturities and is expanding the supply of riskier debt instruments, such as foreign currency denominated domestic bonds. In addition, the issue of public debt seems to crowd out bank credit to the private sector. The growth of bank loans to the private sector moderated to 6.6% yoy in March compared to 8.3% yoy a month before and 9.6% yoy in 2011.

April 2012

	2007	2008	2009	2010	2011	2012f
GDP growth, % yoy	7.9	2.3	-14.8	4.1	5.2	3.0
GDP per capita, $	3 069	3 891	2 545	2 974	3 608	4 000
Industrial production, % yoy	7.6	-5.2	-21.9	11.2	7.6	3.0
Retail sales, % yoy	28.9	18.1	-16.6	9.8	14.7	–
Budget deficit, % GDP*	-1.7	-2.0	-8.9	-7.0	-4.4	-3.5
Government external debt, % GDP	8.7	9.3	20.5	23.8	21.0	19.0
Inflation, eop	16.6	22.3	12.3	9.1	4.6	7-8
Gross international reserves, $ billion	32.5	31.5	26.5	34.5	31.8	26.0
Current account balance, % GDP	-3.7	-7.0	-1.5	-1.9	-5.5	-4.7
Gross external debt, % GDP	56.1	56.5	88.2	86.0	76.6	67.0

**Including implicit pension fund deficit in 2007-2009, and including Naftogaz and pension fund deficits since 2009 (not including bank recapitalization expenditures and VAT refund bonds).*
Revised data for 2009-2010.
Source: State Statistics Committee of Ukraine, NBU, Ministry of Finance of Ukraine, 2011 Budget Law, The Bleyzer Foundation

Economic Growth

In March 2012, the Ukrainian economy continued to expand but at a slower pace. Strong consumer spending, supported by a 14.7% yoy increase in real wages, underpinned a 14.2% yoy increase in retail sales and a 7.4% yoy rise in restaurant turnover over 1Q 2012. At the same time, fears that severe frosts during January-February could further damage winter agricultural crops did not materialize. As a result, agricultural output growth slightly accelerated to 0.7% yoy in March, while official 2012 grain harvest forecast was improved to 45-50 million tons. Benefiting from a record high 2011 agricultural harvest, output growth in food processing accelerated to 2.4% yoy in March, up from 0.8% yoy increase in the previous month.

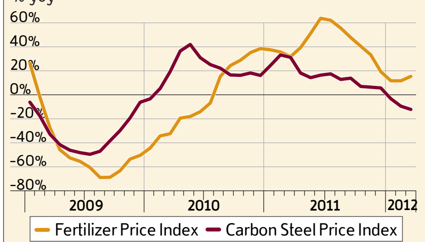
Real Sector Performance of Ukraine
% yoy

	Jan-March 2012	Jan-March 2011	2011	2010	2009
Agriculture	0.5	5.3	17.5	-1.5	-1.8
Industrial output	0.9	10.3	7.6	11.2	-21.9
Construction works	-2.7	6.8	11.1	-5.4	-48.2
Domestic trade turnover					
Wholesale trade	-0.8	9.7	0.6	0.4	-19.3
Retail trade	14.2	13.5	14.7	9.8	-17.4
Restaurants	7.4	8.5	11.0	3.5	-15.6
Transportation turnover					
Cargo	-7.8	13.1	5.7	6.4	-22.5
Passenger	-0.1	3.6	3.3	-0.2	-11.5
Services, non-financial	14.1	16.5	18.6	2.9	-16.8

Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

These gains, however, were offset by further weakening in export-oriented industries and related sectors. Some of the domestic factors, which lost their intensity in March, also contributed. Thus, metallurgical output fell by 1.6% yoy in March. Growth slowdown in Ukraine's main trading partners and complicated trade relations with Russia caused a 5.6% yoy decline in production of machinery and transport vehicles. Due to lower metallurgical production and ongoing depression in domestic oil-refining, the coke- and oil-refining industry reported a 20.7% yoy decline in output. Elevated world energy prices amid outdated technology with low refining depth at domestic oil-refineries and tight competition from imported petroleum products from Customs Union countries, which faced preferential prices on Russian crude oil, led to a gradual closure of Ukrainian oil-refineries. As of mid-March 2012, only one out of six oil-refineries continued to work in Ukraine while the share of imported gasoline products approached 80%. Furthermore, as the impact of adverse weather conditions of the last two winter months subsided, so did demand for energy resources. Thus, production of electricity was only 0.1% yoy higher in March 2012, which contrasts with a 12.3% yoy increase reported for February. As a result, total industrial production declined by 1.1% yoy in March.

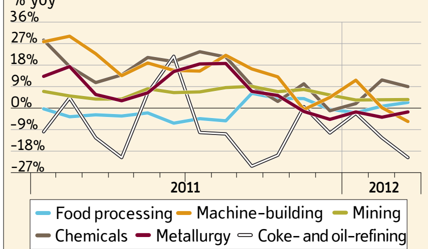
World Steel and Fertilizer Price Indices
% yoy



Source: MEPS, WB GEM databank

Weaker external trade and industrial activity as well as Russia's rerouting of its natural gas transit through pipelines bypassing Ukraine led to an almost 8% yoy decrease in cargo transportation turnover in 1Q 2012. In addition, the real value of construction works fell by 2.7% yoy in 1Q 2012 amid the completion of large infrastructure projects related to the Euro 2012 football championship. At the same time, ongoing deterioration in the sector also implies subdued business investment, restrained by a complicated business environment, difficulties in raising financing at both domestic and foreign financial markets, and higher uncertainties related to the coming parliamentary elections.

Industrial Production Growth by Select Branches
% yoy



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Overall, according to provisional estimates, real GDP growth slowed to 1.8% yoy in 1Q 2012, compared to 4.7% yoy in 4Q 2011. The growth is forecast to rebound to about 3% yoy for the year 2012 as we expect some improvement in the external environment in the second half of the year and private consumption will remain strong supported by pre-election fiscal loosening.

Fiscal Policy

For 1Q 2012, the state budget stayed in surplus thanks to stronger than expected budget revenue growth. State budget proceeds grew by a nominal 16.3% yoy in 1Q 2012 with tax revenues exceeding the period target by 1.1%, according to the State Treasury of Ukraine. Above-plan revenue growth led the government to amend Ukraine's state budget law to increase social expenditures. In particular, state budget expenditures were increased by 9.3% over the initial target to UAH 391.4 billion ($48.9 billion). However, as the revenue plan was amended to fully cover expenditure increases, the state budget deficit target was left unchanged at 1.7% of GDP. Correspondingly, we kept our full-year consolidated public sector deficit forecast (including Naftogaz and pension fund deficits) at about 3.5% of GDP in 2012.

Main State Budget Indicators for 2011-2012

	2011	2012			
	Actual	Previous target	% to 2011	April's Amendments	% to 2011
Revenues, UAH billion	314.6	332.8	5.8	366.6	16.5
Expenditures*, UAH billion	338.2	358.0	5.8	391.8	15.8
Balance, UAH billion	-23.6	-25.1	6.7	-25.1	6.7
% of GDP	**-1.8**	**-1.7**		**-1.7**	

Including net credit from the Budget
Source: MinFin, The Bleyzer Foundation

Despite favorable budget performance in 1Q 2012, the sustainability of public finances remains one of the main macroeconomic challenges for Ukraine in the near term. First, deeper budget revenue data raises some concerns. Thus, a strong increase in proceeds from the corporate profit tax (+25% yoy in 1Q 2012) and import taxes (+35% yoy) amid moderation of economic activity and imports may signal increasing tax pressure. This is also confirmed by a number of business and investor opinion surveys. Moreover, the growth of corporate tax proceeds may be misleading as advance tax payments are a usual practice, while the amount of taxes paid in advance is not reported. In addition, the National Bank of Ukraine transferred UAH 2.4 billion of its profits to the state coffers in March, which represents almost 9.5% of total state budget revenues for that month. Excluding NBU transfers, state budget revenues were only 6% yoy higher in March 2012. Hence, the new revenue growth target of 16.5% yoy for the full year may be a challenging task.

Second, due to the announced fiscal loosening, with most spending increases being recurrent, fiscal consolidation will proceed slower than projected. The full-year public sector deficit (including Naftogaz and pension fund deficits), forecast at about 3.5% of GDP in 2012, will again exceed the target agreed with the IMF (2.5% of GDP). The higher deficit will mainly be the result of Naftogaz imbalances. Due to the reluctance of the Ukrainian authorities to increase natural gas tariffs to the population and thermal power utilities amid high prices on imported natural gas[1], the Ukrainian natural gas monopoly Naftogaz continues to generate a high deficit. In 2011, the Naftogaz deficit grew 13.2% yoy to UAH 20.6 billion ($2.6 billion), or 1.6% of GDP, which was almost on par with the state budget deficit. The deficit is covered through borrowed funds from commercial banks (domestic and foreign, principally Russian) and recapitalization of Naftogaz charter capital by the government issuance of domestic debt securities[2]. According to the State Budget Law, the government plans to issue UAH 12 billion ($1.5 billion) of domestic bonds in 2012. Already in March 2012, Naftogaz charter capital was increased by UAH 6 billion. In addition, the Ukrainian state monopoly borrowed $2 billion from Russian Gazprombank at the end of March 2012 to pay for natural gas to fill its underground gas storage, necessary to prepare for the next heating season. All of this signals a very tight Naftogaz financial situation.

Third, Ukraine's public debt in terms of GDP is not large by international standards (around 37% of GDP in 2011). However, high debt service payments narrow the government's room to maneuver in case of adverse developments. Furthermore, high public debt service needs amid turbulent international financial markets increased the government reliance on domestic debt securities. Over January-March 2012, the government borrowed almost UAH 15.5 billion ($2 billion), excluding domestic debt securities issued to recapitalize Naftogaz. About 96% of these funds were attracted on the domestic market. However, to make domestic securities attractive, the government is accepting rather high yields on short maturities[3] and is expanding the supply of riskier debt instruments, such as foreign currency denominated domestic bonds[4]. The issue of public debt, however, seems to crowd out bank credit to the private sector.

Monetary Policy

In March 2012, on the inflation front Ukraine kept benefiting from a favorable base effect and low food price growth. Consumer prices added only 0.3% from the previous month, while in annual terms inflation eased to 1.9% yoy, one of the lowest levels in the region. Food prices declined 2% yoy in March with prices on vegetables, fruit and sugar reporting the largest declines (-52% yoy, -6% yoy and -29% yoy, respectively). Thanks to a favorable base for comparison, utility service prices moderated to 2.3% yoy that month despite an about 8% increase in water and sewage tariffs in March and some other accommodation costs. Lower contributions from food prices and services compensated for a sharper increase in fuel prices. Amid elevated world energy prices and depressed domestic oil-refining, domestic fuel and diesel prices started to rise, advancing by 2.6% mom in March. Correspondingly, the cost of urban and city

[1]The 2012 State Budget Law was developed based on annual average price for Russian gas at $416 per 1000 m3, which is almost 35% higher than in the previous year. At the same time, given elevated world energy prices, the annual price can be even higher for Ukraine. Thus, the price for natural gas grew from $416 per 1000 m3 in 1Q 2012 to $425 per 1000 m3 in 2Q 2012.

[2]These bonds are then sold by Naftogaz to commercial banks or monetized by the NBU.

[3]Almost 60% of domestic bonds issued during January-March 2012 mature in less than one year, yielding a weighted average 13.3% pa.

[4]In 1Q 2012, the government issued $0.5 billion USD-denominated domestic securities with 9.3% pa average yield, most of which mature in 1-1.5 years.

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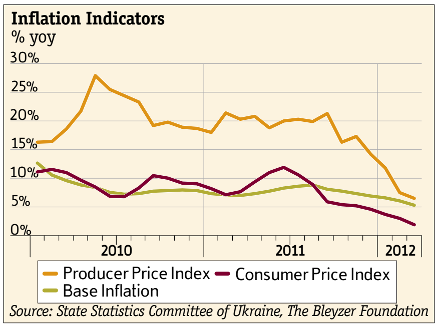
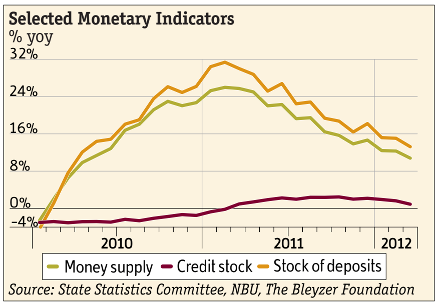
transportation added 1.2% mom. However, thanks to a high base effect, the transportation index eased to 12.3% in annual terms in March, down from 15.6% yoy a month before.

Excluding volatile energy and food prices and administratively regulated tariffs, the core inflation rate slowed to 5.3% yoy in March compared with 6.1% yoy in February. In addition, the producer price index, though rising by 1.1% mom in March, moderated to 6.5% yoy in annual terms. With all three indices signaling easing inflationary pressures, we have revised our year-end consumer inflation forecast downwards to 7-8% yoy in 2012. This projection foresees acceleration in price growth in 2H 2012 amid waning statistical effects, producer costs gaining momentum due to elevated energy prices, looser fiscal and monetary policies.



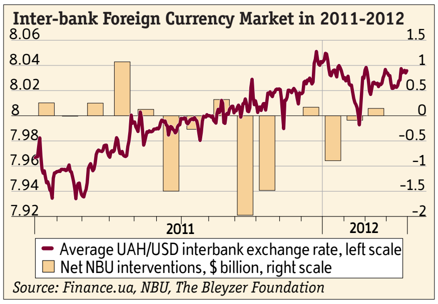
Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Low inflation may also be attributed to moderate growth of monetary aggregates over the period. Thus, the monetary base grew by 2% mom in March amid improved commercial bank liquidity, higher NBU refinancing operations as well as small but positive (net purchase) NBU interventions on Ukraine's forex market. In annual terms, monetary base growth moderated to 4.3% yoy in March compared to 5% yoy a month before. As Hryvnia depreciation pressures subsided over February-March and consumer inflation recorded an almost decade low, the stock of Hryvnia deposits recovered growth, expanding by 4% mom in March. Although foreign-currency denominated deposits fell by 1.7% mom for the same reasons, total private sector deposits grew by 1.5% mom that month. Despite a strengthening deposit base, in annual terms the stock of deposits grew more slowly at 13.2% yoy in March compared to 15% yoy a month before. Correspondingly, money supply (M3) growth also slowed to 10.8% yoy in March.



Source: State Statistics Committee, NBU, The Bleyzer Foundation

Improved banking sector liquidity, however, had a rather limited impact on commercial banks' lending activity. Loans to the private sector grew by a meager 0.2% mom in March. The annual growth rate of loans stood at 6.6% yoy, lower than in February. March's monetary policy loosening (reduction of NBU discount rate to 7.5% pa and relaxation of some reserve requirements) was aimed at stimulating credit growth. Despite these efforts, we believe credit growth will remain weak this year. High credit risk, ongoing clearing of non-performing loans off commercial banks' balance sheets (which still account for about 40% of total bank loans) and purchases of government bonds will be the main reasons for subdued credit growth this year. Thus, the first three reasons keep credit rates high despite easing inflation and liquidity pressures. In March, the weighted average lending rate even grew to 15.9% pa from 15.3% pa reported in February. At the end of March, commercial banks' holdings of government securities were almost 14% higher than at the end of 2011 and kept growing in April.



Source: Finance.ua, NBU, The Bleyzer Foundation

During February-April, the foreign exchange market was virtually calm with the Hryvnia exchange rate fluctuating within a narrow band of UAH 8.02-8.04 per USD. At the same time, Ukraine's high external financing needs amid turbulent international financial markets may generate depreciation pressures throughout the year. Combined with high policy uncertainties related to parliamentary elections scheduled for late October 2012, possible exchange rate pressures also weigh on bank lending activity.

International Trade and Capital

Due to weak foreign demand, despite some tentative signal of a gradual recovery of the world economy, exports of Ukrainian goods dropped 2.5% yoy in March, for the first time since the end of 2009. Shipments of metallurgical and mineral products fell the most and were 17-18% lower than in the corresponding month last year. At the same time, exports of machinery and transport vehicles slowed to 2% yoy in March, affected by growth moderation and worsening trade relations with Russia, the main export market for Ukraine's heavy machinery. On the upside, exports of grains and food products accelerated to 21% yoy in March. Ukraine increased overseas grain shipments in March amid improved its winter crop outlook and high grain stockpiles, which were 36% yoy higher as of April 1st, 2012.

Despite weaker exports, Ukraine's trade balance improved in March as the deficit narrowed to $0.7 billion compared to $1.4 billion a month before. The improvement came as a result of a sharper decline in imports than exports. In particular, imports dropped 3% yoy in March compared to a 5.3% yoy growth a month before. The decline in imports was the reflection of weaker industrial and construction activities. Thus, due to lower volumes of natural gas imports, mineral products imports went down by 24% yoy in March. Imports of metallurgical and wood products fell by 8% yoy and 9.5% yoy respectively. At the same time, robust domestic demand underpinned a 30% yoy increase in imports of machinery and transport vehicles and an 8.5% yoy rise in food imports.

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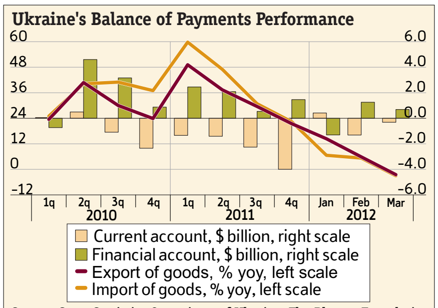

Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Thanks to a narrower foreign trade deficit, the current account gap amounted to a moderate $0.3 billion in March compared to a $1.3 billion deficit a month before. Furthermore, as depreciation pressures subsided since January, so did population demand for foreign currency. In 1Q 2012, net population purchases of foreign currency amounted to about $1.4 billion, 55% lower than in the corresponding period last year. Coupled with solid foreign trade credit inflows and corporate sector borrowings (including borrowings made by state-owned enterprises, such as Naftogaz), this allowed the financial account to stay in surplus of $0.6 billion. As the financial account surplus more than covered the current account gap, the Hryvnia exchange rate remained virtually stable over the month, while the National Bank of Ukraine slightly augmented its gross international reserves to $31.1 billion as of the end of March.

Despite March's improvement, the health of the external sector of Ukraine is among the main macroeconomic concerns for the medium term. At the same time, in our best-case scenario, Ukraine may manage its high total external financing needs even without the IMF program this year, provided that there is no major crisis in Europe. Ukraine's large gross international reserves, relatively low public debt and the authorities' determination to bring public sector finances to a sustainable path may help the private sector to maintain solid debt rollover ratios. In addition, the authorities propose domestic debt securities denominated in foreign currency to tap the opportunity of raising hard currency from domestic market. Although these instruments increase the country's susceptibility to adverse external developments, they may help to meet its external financing needs in the short-term. Finally, there are good chances that the Ukrainian authorities will resume IMF cooperation soon after parliamentary elections. This scenario, however, does not rule out depreciation pressures on the Hryvnia throughout the year.

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