Ukraine – Economic Situation

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Turning Transitions Into Prosperity

May 2012

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- **Ukraine's real sector showed mixed performance in April.**
- **Retail sales and agriculture accelerated over January-April, while industrial production, though flat in April, improved compared to the previous month.**
- **Construction and cargo transportation reported deeper declines.**
- **Fiscal sector liquidity concerns, related to large public debt repayments due in May-June, notably eased following a VTB loan rollover deal.**
- **Consumer inflation slowed to an almost decade low of 0.6% yoy in April.**
- **Exports resumed growth in April. However, the current account deficit widened amid strong imports.**
- **Despite virtually closed foreign financial markets, Ukraine's Balance of Payments improved for the second month in a row.**
- **Hryvnia depreciation pressures intensified at the end of May. As some Hryvnia pressures are believed to be the result of temporary factors, they are likely to be successfully mitigated by the NBU's interventions.**

Executive Summary

April's data for Ukraine's real sector showed a mixed picture. Buoyed by strong real wage growth, retail sales accelerated to 14.8% yoy over January-April. Agriculture also gained momentum, expanding by 1.1% yoy over the period amid a larger spring sowing area. Although industrial production was flat in April compared to the same month of the previous year, it was an improvement from March's decline. The improvement may be attributed to a lower decline in metallurgy, which benefited from the stabilization of world steel prices, though at a low level. In addition, machine building growth recovered amid higher demand from CIS countries. At the same time, the decline in construction and cargo transportation deepened due to completion of large infrastructure projects and lower supply and transit of fossil fuels, respectively.

Fiscal performance was favorable for the first four months of the year thanks to solid budget revenue growth. However, fiscal loosening, in effect since May, and large external public debt service payments (due in late May and June) raised public sector liquidity concerns. These concerns notably eased at the end of May as Ukrainian authorities reached a $2 billion VTB loan rollover deal. In addition, the government has accumulated significant cash balances on its accounts thanks to large privatization receipts and extensive domestic borrowings in both national and foreign currencies.

Consumer inflation kept slowing and reached an almost decade low level of 0.6% yoy in April. Ongoing disinflation was principally the result of food deflation, as a record high 2011 harvest and improved crop outlook for 2012 affected foodstuff prices. At the same time, moderate monetary aggregates growth also contributed. Although monetary authorities are taking steps to stimulate bank lending, the effectiveness of these measures is undermined by the NBU's Hryvnia exchange rate stability target. Thus, to keep Hryvnia fluctuations within a narrow band, the NBU continued to tightly control banking sector liquidity.

Ukraine's Balance of Payments improved for the second month in a row. Thanks to higher volumes of grain exports and heavy machinery deliveries to CIS countries, exports restored growth in April, advancing by 3.2% yoy. However, imports also gained momentum, supported by strong domestic demand. At the same time, a higher current account deficit was more than covered by stronger private (or quasi-public) external debt inflows. As a result, Hryvnia remained virtually stable over April, while the NBU augmented its gross international reserves to $31.7 billion as of end of the month. Larger foreign debt payments due at the end of May and in June, combined with stronger demand for foreign currency (likely related to seasonal repayment of dividends abroad), resulted in higher Hryvnia depreciation pressures at the end of May. Available NBU international reserves, recent large public debt rollover deal and anticipated foreign currency inflows, related to the Euro-2012 football championship, give reason to suggest that these pressures may be temporary and successfully mitigated through NBU interventions.

	2007	2008	2009	2010	2011	2012f
GDP growth, % yoy	7.9	2.3	-14.8	4.1	5.2	3.0
GDP per capita, $	3069.0	3891.0	2545.0	2974.0	3608.0	4000.0
Industrial production, % yoy	7.6	-5.2	-21.9	11.2	7.6	3.0
Retail sales, % yoy	28.9	18.1	-17.4	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

Where Opportunities Emerge.

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Economic Growth

Ukraine's real sector showed mixed performance in April 2012. Retail sales turnover growth accelerated to 14.8% yoy in January-April as an almost decade low inflation rate and loose fiscal policy supported a double-digit increase in real wages. Wholesale trade turnover rose by 0.2% yoy over January-April compared to a decline of 0.8% yoy in 1Q 2012. The improvement may be attributed to higher sales of agricultural products, particularly grains.

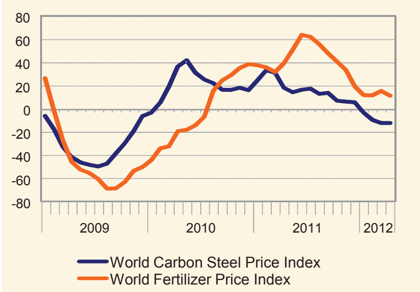
Real Sector Performance of Ukraine, % yoy

	4m2012	3m2012	2011	2010	2009
Agriculture	1.1	0.5	17.5	-1.5	-2
Industry	0.7	0.9	7.6	11.2	-22
Construction works	-3	-2.7	11.1	-5.4	-48
Domestic trade, turnover					
Wholesale trade	0.2	-0.8	0.6	0.4	-19
Retail trade	14.8	14.2	14.7	9.8	-17
Restaurants	7.2	7.4	11	3.5	-16
Transportation, turnover					
Cargo	-9.2	-7.8	5.7	6.4	-23
Passenger	-0.1	-0.1	3.3	-0.2	-12
Services, non-financial	13.8	14.1	18.6	2.9	-17

Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Thanks to favorable weather and a larger spring planting area (mainly as a result of the need to replant larger areas of damaged or lost winter crops), agricultural production sped up to 1.1% yoy in January-April 2012 compared to 0.5% yoy in January-March. Wheat and barley production is expected to be notably lower than last year as these crops suffered from droughty weather during fall sowing and severe winter frosts. However, to compensate for the winter crop losses, Ukraine increased corn and sunflower planting areas by 52.4% yoy and 31.5% yoy, respectively, as of May3rd, according to the State Statistics Committee of Ukraine. As a result, Ukraine may produce record harvests of corn and sunflower seeds in 2012. Overall, the Ukrainian government forecasts the grain harvest to reach 45-50 million tons in 2012, which will be above the 5-year average .

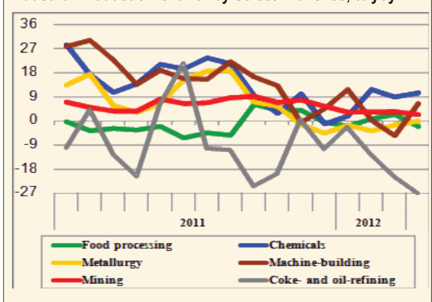
World Steel and Fertilizer Price Indices, % yoy



Source: MEPS, WB GEM databank

In April, industrial production remained unchanged compared to the respective month of the previous year. This, however, was an improvement from a 1.1% yoy decline in output in March 2012, which reflected gains in machine building, chemicals and metallurgy. Thus, Ukraine's machine building recovered to growth in April reporting a 6.5% yoy increase in output. Though favorable base effect contributed to this improvement, the industry was mainly boosted by higher production of railroad freight and passenger cars amid domestic and select CIS countries' plans to renovate their ageing railway fleets. Elevated world fertilizer prices supported Ukraine's chemical industry, which expanded by 10.5% yoy in April, up from 9%yoy a month earlier. As world steel prices seemed to stabilize during March-April, Ukrainian production of metallurgical products was down by only 0.2% yoy in April, a promising development compared to a 2.3% yoy fall in output in 1Q 2012.

Industrial Production Growth by Select Branches, % yoy



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

The gains in the above-mentioned industries, however, were offset by weaker food processing and deeper contraction in oil refining. Following solid growth of 2.4% yoy in March, food processing fell by 2.1% yoy in April. The decline was mainly led by lower meat and cheese production. Production of these foodstuffs was under pressure given the ongoing contraction in livestock and pig population as well as Russia's restrictions on imports of cheese manufactured in Ukraine. Following the closure of Lysychansk refinery, one of the largest in Ukraine, by Russian oil and gas company TNK-BP at the beginning of March 2012, only one (out of six) oil-refining plant continued to work. Lysychansk plant was closed, as it could not compete with cheaper fuel imports from Russia and Belarus, as oil-refineries there did not pay the crude oil export duty imposed by Russia. As a result, Ukraine's output in coke and oil-refining industry was down by almost 27% yoy in April.

Depression in the oil-refining industry, weak metallurgy and construction activity as well as lower transit shipments of natural gas weighed on transportation sector performance. The real value of freight transportation services fell by 9.2% yoy in January-April with cargo traffic carried by Ukrainian pipelines down by about 15% yoy in January-April. Freight railway shipments declined by 0.8% yoy over the first four months of the year, which may be attributed to a deficit of freight wagons. In addition to the above-mentioned reasons, the sector may be affected by uncertainties related to the forthcoming enforcement of the new Customs Code of Ukraine. Approved in mid-March 2012, the new Code will enter into force on June 1st, 2012. While the Code simplifies customs procedures and narrows the power of customs authorities, significant changes in customs regulations with a number of unclear treatments may restrain import and transit freight services.

All in all, April's real sector performance was in line with our expectations of full-year real GDP growth of about 3% yoy in 2012. Private consumption, stimulated by loose fiscal policy, will be the main locomotive of economic growth this year. At the same time, agriculture, forecast to produce record high harvests of selected grains and above-average overall harvest, will also remain an important growth driver.

[1]The average harvest for the last five years is the highest level since the country's independence, as over the period Ukraine recorded three years of very high harvests: a record high in 2011, the second and the fourth highest in 2008 and 2009, respectively.

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Fiscal Policy

State budget performance looked strong during the first four months of the year. According to the State Treasury of Ukraine, state budget revenues rose by 12.3% yoy over January-April and were 1.5% above the period target. At the same time, as anticipated, budget revenue growth moderated compared with 16.3% yoy increase in 1Q 2012, which may be attributed to waning positive statistical base effect, related enforcement of New Tax Code in April last year, and more moderate nominal GDP growth due to a sharp slowdown in inflation. Though expenditure data was not available at press time, budget spending likely accelerated as minimum and living wages were raised by about 1.9% since the beginning of April. Moreover, expenditures from the state budget are forecast to gain momentum in the coming months due to larger hikes in pensions and other social spending approved in mid-April. In addition, large external public debt service payments are due during end-May and June. As a result, fiscal balance is likely to deteriorate in the coming months.

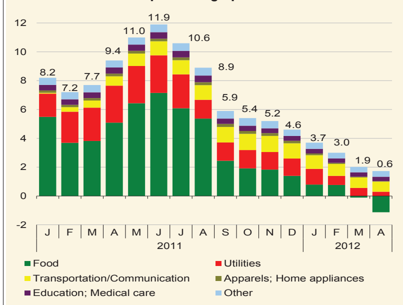
Moreover, fiscal loosening and high public debt repayments in May-June raises public sector liquidity concerns, though the government has accumulated significant cash balances on its accounts. Thus, by mid-May privatization receipts amounted to UAH 5.1 billion ($0.6 billion) thanks to sale of government shares in a number of energy generating companies (oblenergos). Though access to foreign financial markets was virtually closed during the period, the government was quite active on domestic borrowing market. In addition to regular Hryvnia-denominated bonds, the Ukrainian authorities actively proposed domestic securities, denominated in foreign currency, seizing an opportunity of large foreign currency holdings by the Ukrainian banking and private sectors. However, debt repayments due in the next few months are also large. Indeed, at the end of May the government has to repay about $0.6 billion of debt service to the IMF. In June, $0.5 billion of Eurobonds and $2 billion of a VTB loan are due.

Public sector liquidity concerns, however, notably eased in the second half of the year as the Ukrainian government reached an agreement on a VTB loan rollover. In particular, the government and the bank authorities agreed on a new $0.5 billion loan to Ukraine. In addition, Ukraine will issue $1 billion of domestic foreign currency denominated bonds at below market price. Despite current favorable fiscal developments, the government may find it increasingly difficult to secure sufficient funds to successfully meet its fiscal liabilities amid ongoing turbulences on external financial markets and tight domestic liquidity.

Monetary Policy

Consumer inflation continued to decelerate in April, reaching 0.6% in annual terms. Consumer prices remained flat in April compared to the previous month as higher fuel prices and railway transportation costs (5.1% mom and 3.5% mom respectively) were offset by continuing foodstuffs deflation and downward adjustment of hot water and heating costs after the end of the heating season. In particular, food prices fell by 0.3% mom in April, bringing the annual decline to almost 4%. As in the previous months, prices on vegetables, sugar and cooking oil showed the most significant declines, benefiting from plentiful supply thanks to a record high harvest of the previous year. At the same time, Russia's restrictions on cheese imports from Ukraine weighed on domestic cheese and dairy prices, which fell by 1.3% mom and3% mom respectively in April.

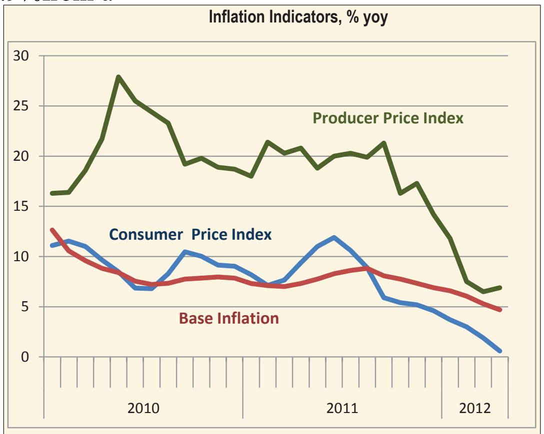
Consumer Price Inflation, % yoy, and Contributions to Growth by Main Commodity Groups, percentage points



Source: State Statistics Committee, The Bleyzer Foundation

The core inflation rate, which excludes volatile energy, food and administratively regulated prices, has also decelerated to 4.7% yoy in April from 5.3% yoy in March. Though both indices signaled about lower inflationary pressure, the disinflation period may bottom out in the coming few months. First, the producer price growth accelerated in April to 6.9%from a year earlier. Though there is a time lag and some asymmetry between producer and consumer prices, higher producer prices will pressure retail prices too. Second, announced pre-election pension and wage increases will push consumer prices upwards. Third, the favorable base effect related to the impact of a record high agricultural harvest of the previous year on food prices will vanish in the second half of the year. Finally, reluctant to raise utility tariffs in the run-up to parliamentary elections, the authorities may agree on some adjustment after elections. On a positive note, though lower than last year, this year harvest is forecast to be in the top six highest, which would help contain the growth of food prices. As a result, consumer inflation is forecast to accelerate to 7-8% yoy at the end of the year. At the same time, despite acceleration in the second half of the year, Ukraine's average inflation rate forecast at about 3% yoy will be the lowest in ten years.

Inflation Indicators, % yoy



Source: State Statistics Committee, The Bleyzer Foundation

So far, low inflation levels are also supported by moderation of monetary aggregates growth. Though the monetary base added 1.6% mom in April, in annual terms it

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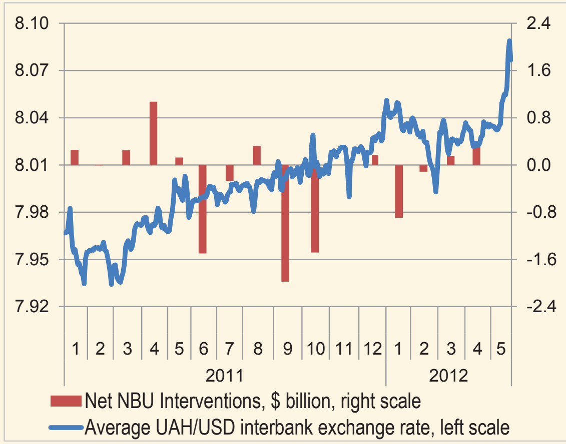
kept decelerating and was only 3.2% higher than in the respective month last year. The rise in monetary base was underpinned by positive NBU interventions on the interbank forex market in April (the NBU purchased EUR 230 million), a 1.5% reduction in government accounts with NBU, some relaxation of reserve requirements for commercial banks and solid NBU refinancing operations. On the other hand, the increase was partially compensated for by larger sterilization operations in April. The National Bank of Ukraine sterilized about UAH 8.2 billion ($1.1 billion) in April alone, compared to UAH 1.8 billion ($0.2 billion) for 1Q 2012.

The growth in broad money supply (M3) also decelerated and reached 9.2% in annual terms in April. In addition to slower growth in monetary base, deceleration in money supply was due to weaker deposit mobilization. Thus, Ukrainian bank deposits fell 0.8% in April from the previous month after a solid increase of 2.1% mom in March. The decline was led by deposits held by non-financial corporations, which fell by 3% mom in April. This decline may reflect businesses tax payments for 1Q2012, slower economic activity and lower bank credit availability. In addition, population continued reducing their foreign currency holdings at commercial banks amid subsided Hryvnia depreciation pressures during February-April and more attractive real deposit rate on Hryvnia deposits, in part thanks to a decade low inflation rate.

The flow of bank loans to the private sector kept slowing over the month. The stock of bank loans expanded by only 0.5% mom in April, bringing the annual growth down to 5.6% yoy from 6.4% yoy a month before. Slow credit growth reflects more selective banking lending practices, given economic growth moderation and still high share of non-performing loans, and mixed monetary policy signals. On the one hand, the NBU relaxed monetary policy at the end of March (decreased its discount rate by 250 basis points to 7.5% pa and relaxed some reserve requirements) to encourage growth through lending activity. In May, the NBU again decided to ease reserve requirements. In particular, it reduced the amount of obligatory reserves, which are kept on separate accounts with the NBU, from 60% to 50%. On the other hand, it continued to tightly manage banking sector liquidity through its sterilization operations aimed at preventing Hryvnia exchange rate volatility on foreign exchange market. Indeed, foreign exchange market was quite stable during April-most of May with Hryvnia fluctuating within a narrow band of UAH 8.02-04 per USD. Moreover, in April, for the second months in a row, the NBU carried out small foreign currency purchases to replenish its international reserves.

Inter-bank Foreign Currency Market in 2011-2012



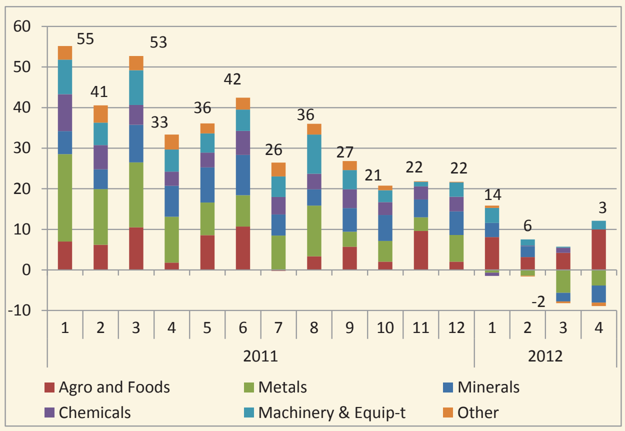
Source: Finance.ua, NBU, The Bleyzer Foundation

At the same time, in mid-May Hryvnia depreciation pressures intensified on the interbank market, with the Hryvnia exchange rate falling to UAH 8.08 per USD, a two-year low. Hryvnia pressures may be attributed to higher external debt payments due in the second half of May and June (debt service payments to the IMF, redemption of Eurobonds and VTB loan), typically large dividend payments on FDIs in May as well as likely higher population demand for foreign currency due to the start of the vacation season. Depreciation pressures throughout the year were generally anticipated due to Ukraine's high external financing needs amid complicated access to foreign financial markets and stalled IMF program. At the same time, we believe that current exchange rate movements are likely to be temporary as pressures will be mitigated by NBU interventions as well as foreign currency inflows related to Euro-2012 football championship. Stronger devaluation, however, might be expected in the fall of this year, particularly after October's parliamentary elections when Hryvnia depreciation will be less politically sensitive.

International Trade and Capital

Record high agricultural harvest and the slow pace of grain exports in the first half of the 2011/12 marketing season allowed Ukraine to accumulate large grain stockpiles. They, in turn, helped supporting Ukraine's export performance in April. Indeed, export of agricultural and food products, which surged by 68% yoy, were the principal driver of total export growth in April. In addition, exports of machinery and transport vehicles gained momentum advancing by 12.8% yoy in April amid higher supplies of heavy machinery to CIS countries (particularly

Export of Goods by Main Commodity Groups, contributions to growth, percentage points



Source: NBU, The Bleyzer Foundation

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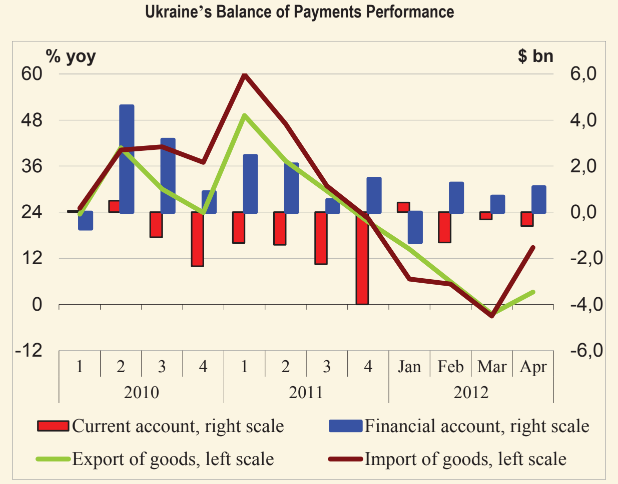
Kazakhstan and Russia). These gains, however, were partially offset by lower exports of metallurgical and mineral products, which fell by 10.5% yoy and 30% yoy respectively in April. While the decline in the former was attributed to a challenging external environment, sharp reduction in minerals exports was mainly a reflection of deep recession in domestic oil-refining industry. Overall, export of goods rose by 3.2% yoy in April, an encouraging development from a 2.5% yoy decline a month before.



Source: NBU, The Bleyzer Foundation

Imports, however, also resumed growth in April, rising by 14.8% yoy. The growth was led by a 50.5% yoy increase in machinery and transport vehicles imports, underpinned by robust domestic consumption and public (or quasi-public) investments to renovate outdated public transportation fleet. On the downside, due to lower volumes of natural gas imports, import of mineral products was down by 3.3% yoy.

As pace of import growth outpaced exports, foreign trade deficit of goods widened to $1.4 billion in April, bringing the four-month cumulative gap to $4.2 billion, which was 11% higher than in January-April 2011. Amid wider foreign trade deficit, current account deficit worsened to $0.6billion in April. Larger deficit, however, was more than covered by higher debt capital inflows.

Within the financial account, net FDI inflows were rather weak, expanding by $122 million in April. To notable extent, FDI inflows to Ukraine are linked to state privatization program, while Greenfield investments are undermined by a complicated investment climate. At the same time, despite a turbulent international financial markets Ukraine's corporate sector external borrowings exceeded repayments by almost $400 million. In addition, for the first time since March 2011, the banking sector suspended the deleveraging process with foreign debt inflows exceeding outflows by about $220 million over the month. Finally, in April population purchases of foreign currency were among the lowest in about two years. As result, financial account surplus reached $1.1 billion. Improved Balance of Payments balance supported Hryvnia foreign exchange rate stability over the month and allowed the NBU to augment its gross international reserves to $31.7 billion as of end-April, though favorable valuation changes also contributed.

Despite favorable Balance of Payments performance over the last few months, the health of the external sector remains one of the main macroeconomic concerns. Thus, current account deficit, though forecast ton arrow slightly to 4.9% of GDP in 2012 compared to 5.5% of GDP a year before, coupled with high share of external debt liabilities due within a year amid turbulent international financial markets generating sufficient foreign financing to meet Ukraine's external financing needs looks rather challenging.