Ukraine – Economic Situation

June 2012

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- **Real sector activity slightly accelerated in May, mainly on account of stronger private consumption and higher public and private spending related to final preparation for the Euro 2012 football championship.**
- **Industrial production expanded by 1% yoy in May, led by faster growth in chemicals, food processing and production of electricity.**
- **Budget expenditures started accelerating in May as the government began fulfillment of presidential social initiatives. In contrast, budget revenues decelerated. Given that real GDP growth and inflation are likely to be lower than anticipated in the budget law and energy sector reform is delayed, the public sector deficit may reach 4% of GDP in 2012.**
- **Ukraine entered a period of deflation in May 2012 with consumer prices falling by a record 1.2% yoy in June. Price developments over 1H 2012 caused us to revise our year-end inflation forecast downwards to about 6%.**
- **Intensified since the second half of May, Hryvnia depreciation pressures were mitigated by the NBU thanks to foreign currency sale interventions and liquidity tightening. These measures, however, caused a 4.7% month-over-month (mom) reduction in gross international reserves and contributed to subdued credit growth.**
- **External sector data showed a favorable Balance of Payments (BoP) picture for the first five months of 2012. However, risks to Ukraine's balance of payments remain high.**

Executive Summary

The Ukrainian economy accelerated in May despite ongoing weaknesses in external demand. Private consumption, supported by a 15.5% yoy increase in real wages over the first five months of the year, remained the main driver of economic growth in 2012. Strong real wage growth was in part due to generous social spending from the budget in the run-up to parliamentary elections and easing price pressures. Retail sales, a substantial portion of consumer spending, picked up by 15.5% yoy over January-May 2012. The improvement in May's real sector performance was also supported by solid growth in agriculture as well as resumed growth in construction and industrial sectors. Thus, agricultural production continued to expand, recording a real increase of 1.5% yoy over January-May. The expansion may be attributed to larger sown area under string crops and a solid advancement in animal farming.

Public and private spending related to the Euro 2012 football championship may explain a rebound in the construction sector, which expanded by 0.3% yoy in real terms over the period, following a 3% yoy decline in January-April. Industrial production rose by real 1% yoy in May compared to a flat output a month before. The main contributions to the sector's growth came from the chemical industry, thanks to strong domestic and overseas demand for fertilizers, food processing and production of electricity. Improvements in these industries helped offset worsened performance in metallurgy, machine-building and oil-refining over the month. Despite May's signs of a gradual activity pick up, we expect the Ukrainian economy to continue growing at a moderate pace, principally as a result of sluggish external demand and tight domestic credit conditions. Moreover, due to a deepening Eurozone crisis, and sharper slowdown in the Asian countries and North America, the real GDP growth forecast was revised down slightly to about 2.0% yoy in 2012.

Inflation pressures continued to ease in Ukraine with year-on-year deflation reported for May and June. Thus, consumer prices were 1.2% lower in June 2012 compared to the respective month last year. In addition to lower cost for foodstuffs, the decline in the consumer price index also reflected declining fuel prices. Considering price developments for the first half of 2012, our year-end inflation forecast was adjusted downwards to 5% yoy. Tight monetary policy also contributed to the decline in inflation. Aimed at containing the recently intensified Hryvnia exchange rate pressures, the NBU intervened in the foreign exchange market by selling its gross international reserves and tightened banking sector liquidity to raise demand for the Hryvnia. While these measures helped to stabilize the Hryvnia exchange rate at about UAH 8.08-8.1 per USD during June, they constrained Hryvnia supply in the economy, further undermining credit growth.

The Balance of Payments situation was uneven during May, although monthly data still reported a favorable picture. Thus, due to acceleration in exports and growth moderation in imports, Ukraine's foreign trade deficit narrowed to $0.8 billion in May. Moreover, thanks to strong foreign currency inflow (mainly on account of trade credit and other short-term capital), the Balance of Payments stayed in surplus for the third month in a row. However, high external debt payments due at the end of May and in June and concerns over the vulnerability of the Ukrainian economy to external shocks amid a deepening Eurozone debt crisis generated high demand for foreign currency since the second half of May. The NBU has mitigated these pressures at a cost of lower international reserves, which fell by 4.7% in June from the previous month. In June, the NBU announced a gradual shift towards a more flexible exchange rate regime, although greater details on the move are still not available. At the same time, the NBU has been taking measures to reduce the reliance of the Ukrainian economy on the US dollar by entering into currency swap agreements with China and Russia. With some of foreign trade contracts settled in local currencies, these efforts can help reduce domestic US dollar demand and the cost of bilateral trade.

	2007	2008	2009	2010	2011	2012f
GDP growth, % yoy	7.9	2.3	-14.8	4.1	5.2	2.0
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	1.5
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	-4.0
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	5.0
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	-4.8
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

Rather unexpectedly, real sector data for May showed acceleration in economic activity. Domestic factors were the principal drivers of the improvement, while external demand remained weak.

Real Sector Performance of Ukraine, % yoy

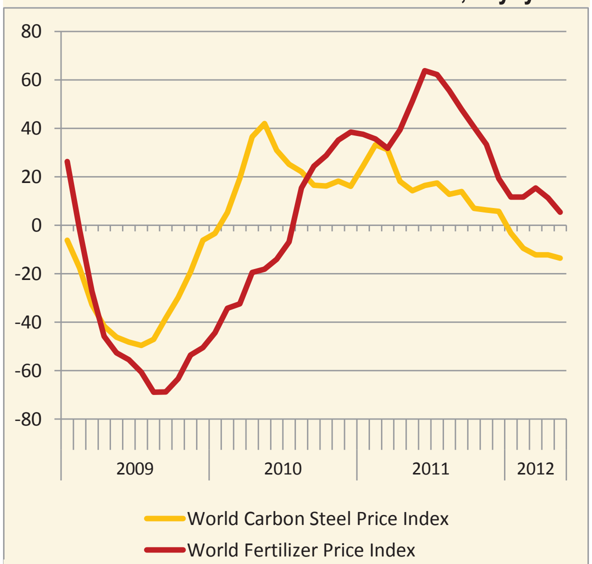
	5m2012	4m2012	2011	2010	2009
Agriculture	1.5	1.1	18	-1.5	-2
Industry	0.7	0.7	7.6	11	-22
Construction works	0.3	-3	11	-5.4	-48
Domestic trade, turnover					
Wholesale trade	0.3	0.2	0.6	0.4	-19
Retail trade	15.5	14.8	15	9.8	-17
Restaurants	7.6	7.2	11	3.5	-16
Transportation, turnover					
Cargo	-9	-9.2	5.7	6.4	-23
Passenger	-0.8	-0.1	3.3	-0.2	-12
Services, non-financial	13.2	13.8	19	2.9	-17

Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Underpinned by strong real wage growth (15.5% yoy over January-May 2012), retail sales picked up 15.5% yoy over the first five months of the year. In turn, robust real wage growth was in part due to generous social spending from the budget in the run-up to the parliamentary elections and a sharp decline in consumer price growth. The agricultural sector also continued to demonstrate solid growth. A 1.5% yoy expansion in the sector is attributed to a larger spring sowing campaign compared to the previous year, as a result of higher replanting of perished winter crops, and advancement in poultry production. The latter benefited from lower feed prices amid a record high 2011 crop harvest and subdued grain exports.

In addition, construction and industrial sectors resumed growth in May. Construction showed a 0.3% yoy expansion over January-May 2012, which followed a 3% yoy decline in January-April. The rebound in the sector may be explained by final preparation works for the Euro-2012 football championship and might be temporary given that the tournament ended at the beginning of July. Industrial production rose by a real 1% yoy in May compared to flat output a month before. The main contributions to the sector's growth came from chemicals, food processing and production of electricity. Production of chemicals rose by almost 15% yoy thanks to healthy domestic and overseas demand for fertilizers. The industry, however, may lose momentum in the coming months as world fertilizer prices have been decelerating. Food processing expanded by 3% yoy that month, mainly driven by higher production of beverages, greater supply of early vegetables and fruits, and solid growth in milk and dairy production. Resumed electricity exports to Poland and higher supplies to Hungary and Belarus underpinned a 5.8% yoy increase in production and distribution of electricity.

World Steel and Fertilizer Price Indices, % yoy



Source: MEPS, WB GEM databank

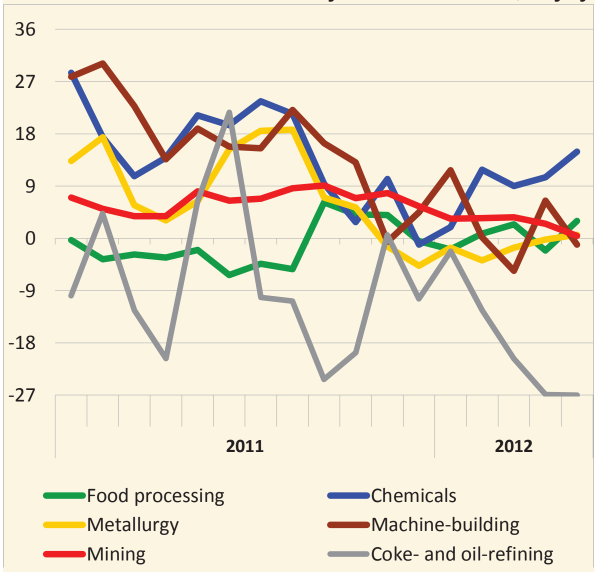
Improvements in these industries helped offset worsened performance in metallurgy, machine-building and oil-refining. The intensified Eurozone crisis in 2Q 2012 and increasing signs of a growth slowdown in Asia and North America have weighed on world commodity prices. Thus, world steel prices were almost 14% lower in May 2012 than a year ago, according to the MEPS global composite index. Given more challenging conditions for exports and softening domestic demand, Ukrainian metallurgical output fell by 1.1% yoy in May. Output growth in machine-building decelerated to

[1]MEPS (International) Ltd., an independent consultancy company operating in the steel sector.

0.5% yoy in May, down from 6.5% yoy a month before. The deceleration in the industry may signal weakening investment activity (e.g., production of special purpose machinery and equipment for metallurgy fell by almost 22% yoy, while production of cars declined by 12% yoy in May). The situation in Ukraine's coke and oil-refining industry remained difficult; the industry reported a 50% yoy decline in production of refined petroleum products on tight import competition and closure of most domestic oil-refineries.

Despite May's improvements, we expect the Ukrainian economy to continue growing at a moderate pace, principally as a result of sluggish external demand and tight domestic credit conditions. Moreover, due to intensified downside risks to global growth (as a result of the deepening Eurozone crisis and a sharper slowdown in Asian countries), we have revised our Ukrainian real GDP forecast downwards slightly to 2.0% yoy in 2012. At the same time, a relatively modest revision reflects our expectations of continued robust growth in private consumption, the main driver of real GDP growth this year. In addition, a good agricultural harvest, though lower than last year, and high grain stockpiles should support exports in the second half of the year.

Industrial Production Growth by Select Branches, % yoy



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Fiscal Policy

State budget data for January-May 2012 kept presenting a relatively strong fiscal picture. Moreover, a $2 billion VTB loan rollover deal and the Ukrainian authorities' bilateral negotiations on loan agreements (e.g., with China) have notably eased short-term fiscal financing needs. However, Ukraine's public finances remain under pressure while the progress of fiscal consolidation efforts may be even slower than initially projected.

Thus, state budget revenues rose by a nominal 12.1% yoy over January-April, decelerating from 12.5% yoy for the first four months of the year. The State Treasury of Ukraine reported that revenues to the general fund of the state budget were in line with the period target and even slightly exceeded the plan by 0.6%. However, the annual revenue collection target may be difficult to achieve due to likely slower than previously projected real GDP and inflation growth this year (the government forecast real GDP and inflation to increase by 3.9% yoy and 7.9% yoy respectively in 2012). In addition, when amending state budget revenue plans in mid-April 2012, the government counted on efforts to improve the efficiency of tax administration and customs procedures, which would increase fiscal discipline. Indeed, while imports of goods grew by about 7% yoy over January-May 2012, budget receipts from import duties picked up by 33% yoy for the period. The growth of proceeds from value added tax on imported goods also noticeably outpaced the growth of imports. On par with improved tax administration and customs procedures, however, these developments may signal increased fiscal pressure on business, which may be a further drag on economic activity.

State budget expenditures, in contrast, started accelerating, advancing by a nominal 13.4% yoy over the first five months of 2012 (up from 12.1% yoy for January-April). The speed-up was led by higher social spending as well as expenditures on economic activity, which may be attributed to the start of implementation of presidential pledges announced in late-March 2012 and final preparations to the Euro 2012 football championship. As a result, the five-month state budget deficit was almost twice as high as in the corresponding period last year.

As fulfillment of presidential social initiatives only started to gain momentum in May, while a number of compensatory measures (such as introduction of the wealth tax) were not introduced, the state budget deficit may exceed the targeted 1.8% of GDP in 2012. Thus, at the end of June, the Cabinet of Ministers worsened the official Pension Fund deficit target, which is covered from the state budget, by 57% to UAH 15.3 billion (1% of GDP). In addition, due to a delay in energy sector reform implementation amid high imported energy prices (the average price for imported Russian natural gas may reach $420-430 per 1000 m3 in 2012, up from about $310 per 1000 m3 in 2011), the deficit of Naftogaz, the state-owned natural gas monopoly, is projected to stay at around 2% of GDP. Hence, the total public sector deficit may reach about 4% of GDP in 2012. Although the government may have sufficient resources to cover its fiscal financing needs this year thanks to robust privatization receipts, a VTB loan rollover and bilateral loan agreements with select countries (China), the slower pace of fiscal consolidation may weaken Ukraine's fiscal position in the longer term.

[2]Since the beginning of 2012, business complaints on over-estimation on the customs value of imported goods have increased. Problems with VAT refund, advance profit tax collections and restrictions on tax losses carry-forward are among other frequent complaints.

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Monetary Policy

Following a sharp decline in inflation over the first four months of the year, Ukraine entered a deflation period in May. The consumer price index fell by 0.5% yoy that month, mainly on account of lower foodstuff prices. Moreover, deflation deepened in June as prices were 1.2% yoy lower compared to June 2011. As in the previous month, the decline was led by a record fall in food prices. As a result of a record high 2011 agricultural harvest and large stockpiles ahead of the new harvest, foodstuffs were 6.4% cheaper in June 2012 than in the corresponding month a year ago.

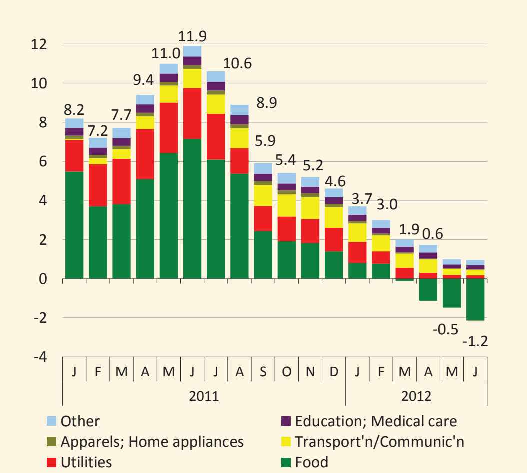
In addition, June's decline in the annual consumer price index also reflected descending fuel prices, falling clothing and footwear prices, as well as government reluctance to raise utility tariffs before parliamentary elections. The decline in domestic fuel prices (-2.5% mom in June), however, was less sharp than might have been expected considering the sharp drop in commodity and oil prices on international markets. The reason may lie in Ukraine's introduction of floating excise duties on petroleum products at the end of May. That means that the rates of excise taxes on fuel rise when crude oil prices fell below a certain threshold and vice versa. Clothing and footwear prices fell by 0.9% yoy in June due to an earlier start of seasonal discounting. The cost of utility services grew by only 0.5% from January to June 2012 compared with a 10% increase for the same period of last year. As a result, in annual terms, they were only 1.6% yoy higher in June 2012. Considering consumer price developments for the first half of 2012, good prospects for the 2012 agricultural harvest and the unlikelihood of change in government policies until after the elections, we have revised downwards our year-end inflation forecast to about 5% in 2012.

Tight monetary policy also contributed strongly to the decline in inflation. Aimed at containing intensified Hryvnia exchange rate pressures (mainly due to larger external debt repayments) at the end of May and in June, the NBU intervened on the foreign exchange market by selling its gross international reserves and tightened banking sector liquidity. Thus, daily cash balances on commercial banks' correspondent accounts fell from about UAH 20 billion on average during April and the first half of May to about UAH 17.5 billion on average in June. A surge in the overnight interbank credit rate from less than 3% pa in March-most of May to 16-17% pa at the end of May and to almost 22% pa by mid-June also signaled a severe liquidity squeeze. To mitigate Hryvnia exchange rate pressures, the NBU sold $0.7 billion on a net basis in June. While these measures helped to stabilize the Hryvnia exchange rate at about UAH 8.08-8.1 per USD during June, they constrained the growth of Hryvnia supply in the economy.

The growth of the monetary base slightly accelerated to 6.6% yoy in June, up from 3.2% yoy in April. The acceleration, to a notable extent, should be attributed to a low base effect, increased NBU refinancing support for commercial banks and a reduction of government cash balances with the NBU. Due to low credit availability and high costs of credit resources, corporate deposits in national currency fell by 1.4% yoy in June. Although the decline was partially offset by solid growth of household deposits in national currency (up by 16.6% yoy), overall the pace of growth of the stock of bank deposits declined to 9.7% yoy in June. Correspondingly, slower deposit creation was the principal reason of moderation of money supply growth to 8.7% yoy in June.

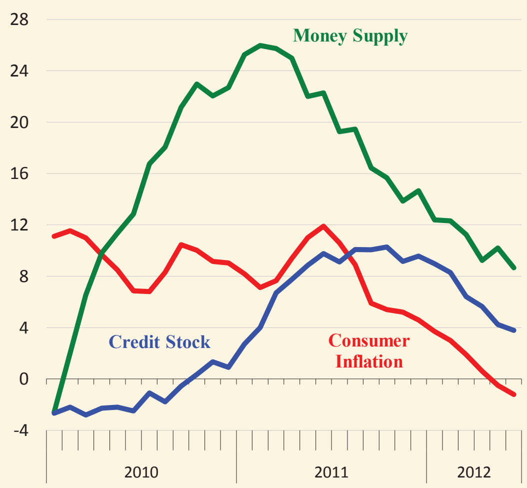
A liquidity shortage and high credit risks underpinned further increase in the bank credit rate, which surged to a weighted monthly average of 17.7% pa in June,

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



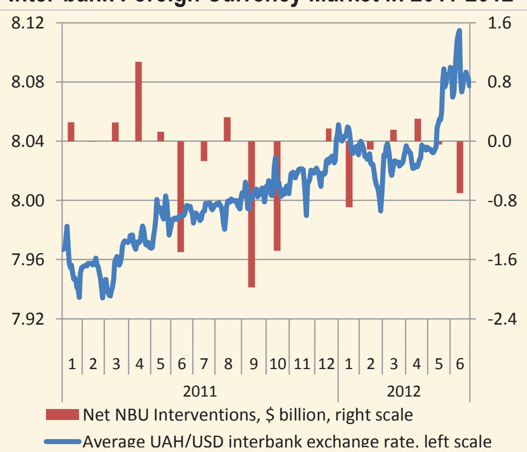
Source: State Statistics Committee, The Bleyzer Foundation

Select Monetary Indicators, % yoy



Source: State Statistics Committee, NBU, The Bleyzer Foundation

Inter-bank Foreign Currency Market in 2011-2012



Source: Finance.ua, NBU, The Bleyzer Foundation up from 14.5% pa a month before. Moreover, high credit and economic risks adversely affect bank lending activity despite NBU efforts to stimulate credit growth. As a result, the stock of bank loans grew by only 0.1% from January to June 2012 and was 3.8% yoy higher in June 2012. Credit activity is likely to remain subdued through the rest of the year, weighing on economic growth, as political uncertainty related to parliamentary elections will add to economic risks faced by commercial banks.

International Trade and Capital

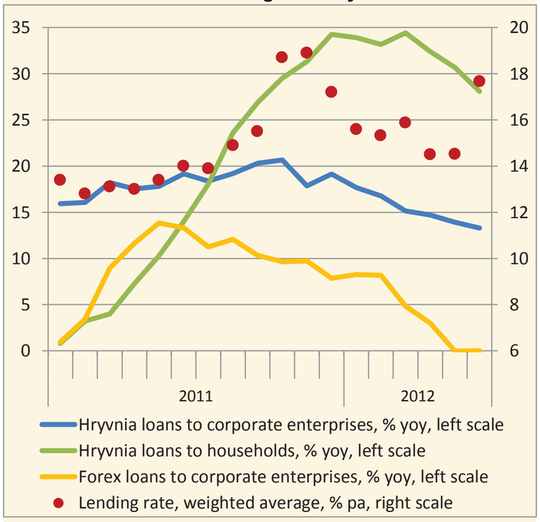
External sector data for May showed a favorable picture. However, risks to Ukraine's balance of payments remain high. Thus, Ukraine's foreign trade balance improved in May thanks to growth in exports and slower imports. Indeed, exports in goods accelerated to 9.4% yoy in May, up from 3.5% yoy in the previous month. Food and agricultural products and machinery and equipment were the principal contributors to export growth. In particular, May's grain exports more than doubled compared to May 2011, while exports of railway locomotives were 1.8 times higher in annual terms. In addition, strong external demand for fertilizers supported Ukraine's exports of chemical products, which increased by 20.6% yoy in May. Furthermore, the decline in exports of metallurgical products slowed from 10.5% yoy in April to 0.3% yoy in May. These improvements helped to compensate for a deeper decline in mineral exports, which is linked to continuing depression in the domestic oil-refining industry.

The recent fall in world crude oil prices and lower volumes of natural gas imports may explain the deceleration in imports to 10.8% yoy in May, down from 14.8% yoy a month before. At the same time, imports of machinery and equipment, the second weightiest commodity group in total Ukraine's imports, kept growing at a robust 48% yoy. Ukraine's foreign trade deficit in goods and services slightly narrowed to $0.8 billion in May from about $1 billion a month before. Although the five-month foreign trade deficit, tallying $3.3 billion, was almost 25% higher than in the respective period last year, the current account showed the same deficit of $2.6 billion as in January-May 2011. This development was achieved thanks to a sharp decrease in the income account deficit, which stood at $0.2 billion in January-May 2012 vs. $1.3 billion a year ago.

In May, Ukraine's financial account of the balance of payments showed a $1.2 billion surplus, mainly on account of strong trade credit and other short-term capital inflows. As a result, the balance of payments stayed in surplus (analytic presentation) for the third month in a row. Despite the surplus, Ukraine's gross international reserves declined by almost 3% in May compared to the previous month to $30.8 billion. This seeming contradiction may be explained by peculiarities of analytic presentation of the Balance of Payments, when the change in reserve assets and the use/repayment on IMF credit and loans are shown 'below the line'. In May, the Ukrainian monetary authorities repaid about $560 million of principal payments to the IMF. Coupled with negative currency valuations (mainly due to Euro depreciation with respect to the US Dollar), this transaction may explain the decline in gross international reserves amid the BoP surplus. Moreover, already in June, the BoP may worsen amid high public external debt repayments (e.g., Eurobonds, VTB loan).

[3]The income account breakdown for April-May 2012 is not available and the differences for 1Q 2012 seem not statistically significant to suggest about the causes of the improvement. At the same time, narrower income account deficit in April-May may be related to foreign currency inflows (in the form of dividend payments, profits from abroad or lower income outflows abroad) to fund forthcoming parliamentary elections.

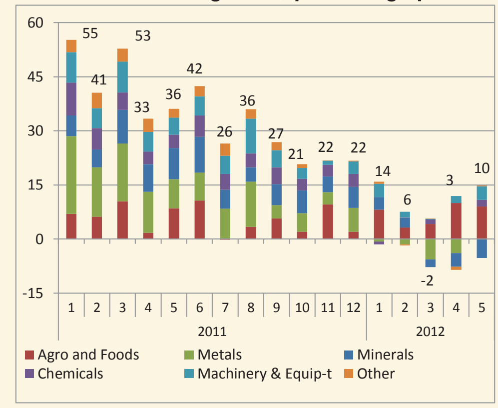
Select Bank Lending Activity Indicators*



** Forex loans to households are forbidden; hence, the stock of such loans (excluding Hryvnia depreciation impact of 2008) has been declining since end-2008*

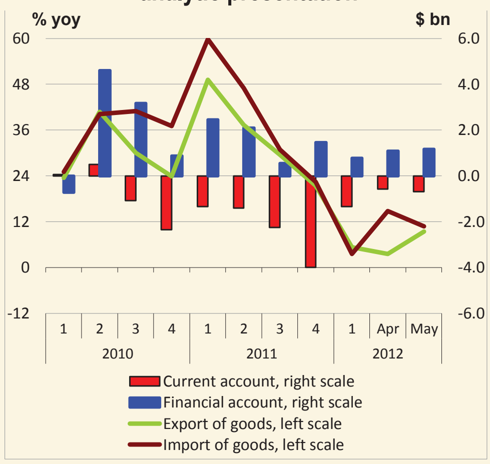
Source: NBU, The Bleyzer Foundation

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



Source: NBU, The Bleyzer Foundation

Ukraine's Balance of Payments Performance, analytic presentation



Source: NBU, The Bleyzer Foundation

Given that access to foreign capital markets remains constrained, Ukrainian authorities have been actively seeking alternative financing to ease potential balance of payments pressures. Thus, at the end of June, Ukraine signed a three-year CNY 15 billion (about $2.4 billion) currency-swap agreement with China and intends to sign currency swap agreement with Russia. With some foreign trade contracts settled in local currencies, these efforts may help reduce pressures on Ukraine's gross international reserves and may reduce the cost of bilateral trade between the countries. In addition, the Ukrainian government is negotiating several loan agreements with China (e.g., on agriculture), which will help cover Ukraine's high foreign financing needs. Despite favorable five-month performance and the above-mentioned measures, Ukraine's BoP may be under pressure in the short term due to high external debt (both public and private) repayment needs and stronger foreign currency demand related to increasing political uncertainty ahead of the October elections.

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