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Ukraine Macroeconomic Situation

THE BLEYZER FOUNDATION
Turning Transitions Into Prosperity

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- **According to preliminary estimates, real GDP growth exceeded 5% yoy in 1Q 2011.**
- **In 1Q 2011, the state budget deficit stood at UAH 0.9 billion or less than 0.1% of full-year GDP.**
- **Given government plans to ease expenditures on public sector wages and likely higher Naftogaz and Pension Fund deficits, the achievement of the targeted 3.5% of GDP broad fiscal deficit at the year-end looks very challenging in 2011.**
- **Annual inflation accelerated to 9.4% yoy in April. Alternative sources show that official food inflation is notably underestimated.**
- **The current account deficit narrowed to $0.1 billion in March thanks to an improved trade balance.**
- **The capital and financial account switched to a deficit in March amid high external debt repayments; however, it is projected to notably improve in April-May.**
- **NBU gross international reserves grew to a record high $38.4 billion in April.**
- **The foreign exchange market may become more volatile given NBU plans to liberalize foreign exchange transactions and uncertain prospects with the next IMF tranche disbursement.**
- **The Ukrainian authorities plan to introduce a full-fledged agricultural land market at the beginning of 2012. Although in theory this is desirable, the decision may destabilize sector performance.**

Executive Summary

A favorable external environment and strong growth in domestic demand supported solid growth of the Ukrainian economy in the first quarter of 2011. According to preliminary NBU estimates, real GDP grew by more than 5% yoy over the period. By sector, the growth was led by the industrial sector, as industrial production grew by 9.7% yoy over the first three months of the year. In March, however, growth in the industrial sector eased to 8% yoy, mainly on account of slower growth in export-oriented metallurgy, machinery and chemicals. The weaknesses in the industrial sector were compensated for by better performance of domestic demand driven retail trade, construction and services.

Ukraine enjoyed a small state budget deficit in 1Q 2011 thanks to robust revenue growth (+ 28.4% yoy) and a moderate increase in expenditures (16.2% yoy). Although improvements in tax collections are evident, a 50% yoy increase in tax receipts may be misleading as it reflects modernization of budget revenue classification and a change in the reporting period for corporate profit tax. The approval of a three-month reduction in excises and full enforcement of the Tax Code since April 1st may cause a deceleration in budget revenue growth. At the same time, impressive first quarter budget performance inspired the government to ease wage expenditures to public sector employees. Given also the likely higher Pension Fund and Naftogaz deficits, the broad fiscal deficit of 3.5% of GDP in 2011 looks very challenging.

Consumer price inflation accelerated to 9.4% yoy in April, driven by faster growth in food, utility and fuel prices. At the same time, alternative estimates show official numbers are likely to underestimate actual price growth in the country. The divergence between official and independent indicators may be explained by differences in methodology as well as larger representation of administrative price controls in the official index.

Although Ukraine's external sector performance notably improved after the crisis of 2008-2009, first quarter indicators demonstrate Ukraine remains quite vulnerable to external circumstances. Thus, Ukraine's current account deficit narrowed considerably in March this year as high world commodity prices supported exports. At the same time, the capital and financial account balance switched to a large surplus in February, moved into a deficit in March and is likely to return to large surpluses in April-May thanks to a number of successful Eurobond placements and privatization of the fixed-line telecommunication monopoly, Ukrtelcom. As the capital and financial account balance heavily depends on foreign investors' willingness to roll-over Ukraine's high external debt financing needs, continued co-operation with the IMF remains crucial for Ukraine. At the same time, weaker policy implementation by Ukrainian authorities makes the disbursement of the next IMF tranche highly uncertain. This uncertainty, coupled with the NBU plans to liberalize foreign currency transactions on the interbank market, may lead to higher Hryvnia foreign exchange volatility in the coming periods.

During March-April, the Ukrainian authorities revealed plans to facilitate introduction of agricultural reform at the beginning of 2012. It is widely recognized that restrictions on land ownership undermine agricultural development. However, the absence of agreement between policy-makers on key issues (land ownership by foreigners, delimitation of land parcels and ensuring their accessibility, timing of the reform – how much land will be allowed to trade during the first year of reform implementation, etc.) as well as a number of shortcomings in the drafted reform legislation raise concerns that hasty reform implementation may destabilize the sector and increase social tensions.

	2006	2007	2008	2009	2010	2011f
GDP growth, % yoy	7.3	7.9	2.3	-14.8	4.2	4.5
GDP per capita, $	2 300	3 070	3 880	2 540	3 030	3 500
Industrial production, % yoy	6.2	10.2	-3.1	-21.9	11.0	
Retail sales, % yoy	24.8	28.8	18.6	-16.6	7.6	
Budget deficit, % GDP*	-0.7	-1.7	-2.0	-8.8	-6.5	-3.5
Government external debt, % GDP	11.0	8.7	9.3	20.5	23.8	25.3
Inflation, eop	11.6	16.6	16.6	12.3	9.1	12.0
Gross international reserves, $ billion	22.4	32.5	32.5	26.5	34.5	32.0
Current account balance, % GDP	-1.5	-3.7	-7.0	-1.7	-1.9	-2.9
Gross external debt, % GDP	50.6	56.0	56.4	88.6	88.1	78.0
Exchange rate, Hryvnia/US Dollar, eop	5.1	5.1	7.7	7.99	7.96	8.2-8.5

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

Where Opportunities Emerge.

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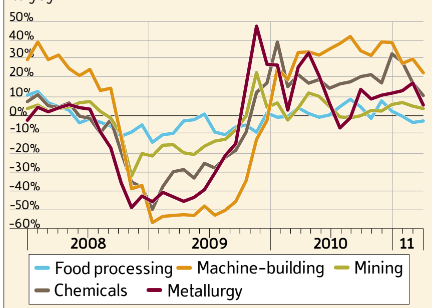
Economic Growth

In March 2011, Ukraine enjoyed solid economic growth as weaknesses in the industrial sector were compensated for by better performance of domestic trade, construction and non-financial services. Given the remarkable start of the Ukrainian economy in the first two months of the year, real GDP was estimated to grow by more than 5% yoy in the first quarter of 2011.

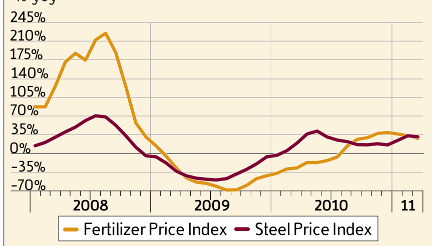
Industrial Production Growth by Select Branches
% yoy



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Industrial activity slowed in March 2011 as the industrial production index reported an 8% increase in annual terms in the month under review after expanding by 11.5% yoy in the previous month. The deceleration, however, was in line with expectations as the growth in the sector was impacted by less favorable external conditions, strict administrative price controls and a growing statistical base. Thus, price controls on food and gasoline products depressed food processing and oil-refining. Output in those industries was down by 2.8% yoy and 21.5% yoy respectively in March 2011.

World Steel and Fertilizer Price Indices
% yoy



Source: MEPS. WB GEM databank

Output in export-oriented metallurgy rose by a modest 5.7% yoy in March, a noticeable slowdown from 15% yoy growth in January-February 2011. The deceleration was the result of both external and domestic factors. The external environment for Ukraine's metallurgy worsened amid continuing turbulence in MENA countries and growing world steel production capacities[1]. Stronger competition amid weaker external demand weighed on export prices of Ukraine's steelmakers. On the domestic front, supply shortages of raw materials (e.g., metal scrap and ores[2]), planned repair works on selected metallurgical plants and a slow VAT refund process[3] may be among the reasons for lower steel production in March 2011. Furthermore, the industry may have seen weaker demand from related branches. Thus, output growth in Ukraine's manufacturing of machinery and transport equipment decelerated from 30% yoy in February 2011 to about 23% yoy in March. While a rising statistical base played a significant role in this deceleration, weaker external demand also contributed.[4]

Production of chemicals rose by 10.7% yoy in March 2011, down from about 23% yoy in the first two months of the year. Weaker industry performance may be attributed to surging energy costs amid virtually flat world fertilizer prices during February-March 2011. At the same time, in mid-April the prime minister of Ukraine announced that Ukraine had negotiated a discount on Russian natural gas for Ukrainian chemical enterprises. Since March 2011, natural gas imported for chemical industry cost \$170 per m^3, while the 'regular' price for imported natural gas stood at \$264 per m^3 in 1Q 2011 and grew to about \$295.6 per m^3 in 2Q 2011. A natural gas price discount and stronger demand for fertilizers may have a positive impact on industry performance in the coming months.

On the upside, due to cold weather in March and resumed exports, production and distribution of electricity picked up by 13.8% yoy in March. Strengthening domestic demand and budget financing of infrastructure construction supported domestic market oriented industries and sectors. Steady real wage growth (11.1% yoy in 1Q 2011) and resuming credit bank credit activity (including consumer credit) underpinned a 13.5% yoy and 8.5% yoy increase in retail trade and restaurants turnover, respectively, over the first quarter of 2011. The value of non-financial services grew by 16.5% yoy in real terms over the period, pointing to buoyant domestic demand. The growth of construction works accelerated to 6.8% yoy in 1Q 2011, mainly underpinned by capital budget financing of Euro-2012 projects.[5] At the same time, continuing depression in residential construction is still restraining growth in the sector.

Rather surprisingly, the growth of agricultural output accelerated to 5.3% yoy in 1Q 2011, up from 5% yoy in the first two months

[1] In addition to China, where crude steel production kept growing buoyantly (up by 9% yoy in March 2011), Turkey, an important export market for Ukraine's steel products, has been actively expanding its steel production capacities. Indeed, according to the World Steel Association, Turkey's steel production was almost 25% higher in March 2011 compared to March 2010.

[2] Due to increasing world iron ore prices, export of ores grew by 92% yoy in 2010 and 113% yoy in the first two months of 2011. Thus, some enterprises that do not have iron ore mines of their own may have faced raw materials supply shortages.

[3] Metallurgy is a heavily export-dependent industry with exports accounting for about 60% of output production (according to National accounts for 2009). Hence, slow VAT refunds may constrain production activity of metallurgical enterprises. For instance, according to ArcelorMittal Kryviy Rih, the largest metallurgical plant in Ukraine, total VAT refund claims stood at about UAH 2.3 billion (\$0.3 billion) at the end of April 2011. Although an 8% yoy decline in enterprise production in 1Q 2011 may be explained by planned repair works, the slow VAT refund is exacting a toll on the capital investments of the company.

[4] According to Balance of Payments data, about 53.5% of Ukraine's exports of machinery and equipment went to Russia in 2010. The Russian State Statistics Service reported Russia's industrial production growth at 5.3% yoy in March 2011, down from 5.8% yoy in February. In addition, capital investments were 0.3% yoy down in March 2011.

[5] According to Ministry of Finance data on budget execution in 1 Q 2011, state budget expenditures on multipurpose development projects (which are very likely related to construction of Euro-2012 infrastructure) grew almost 19 times in 1 Q 2011 compared to the respective period last year.

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of the year, despite rising production costs[6] and extension of grain export restrictions. As the sector's growth over this period is dominated by animal husbandry and poultry raising, further improvements in pig, poultry and eggs production explain the acceleration. However, high forage prices may weaken agricultural performance the coming months. The later start of the spring sowing campaign due to cold weather may also contribute to growth slowdown in the sector. However, thanks to improved investments in agriculture[7] and better conditions of winter crops, Ukraine is projected to have a slightly better grain harvest than in 2010. As result, the sector may report small growth for the whole year. Given the good start in the first three months of 2011, Ukraine's economy is forecast to grow by 4.5% yoy in 2011.

Real Sector Performance of Ukraine
% yoy

	Jan-Mar 2011	Jan-Mar 2010	2010	2009	2008
Agricultural output	5.3	5.3	-1	-1.8	17.1
Industrial output	8	10.8	11	-21.9	-3.1
Construction works	6.8	-21.4	-5.4	-48.2	-15.8
Domestic trade turnover					
Wholesale trade	9.7	4.3	0.4	-19.3	-6
Retail trade	13.5	2.1	7.6	-17.4	18.1
Restaurants	8.5	-3.1	3.5	-15.6	4.6
Transportation turnover					
Cargo	13.1	16.1	6.4	-22.5	-0.2
Passenger	3.6	-5.2	-0.2	-11.5	4.5
Services, non-financial	16.5	-3.8	2.9	-16.8	15.8

Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Agriculture could potentially become the driver of economic growth in Ukraine. Possessing large and fertile land, Ukraine is estimated to produce more than twice as much grain as it harvested on average for the last five years. The potential, however, remains largely untapped despite improved investments in the sector. The reason lies in Ukraine's contradictory agricultural policy. On the one hand, there are a number of state support programs to stimulate agricultural development in Ukraine. On the other hand, the government set narrow grain export quotas despite a sufficient grain stock amid an above-average harvest in 2010 and introduced non-transparent export quota distribution schemes; additionally, several bills were drafted that may lead to state monopolization of grain exports if they are approved by the parliament[8]. While the government stepped back from some of these initiatives[9], the lack of a consistent approach in agricultural market policy creates uncertainty and diverts future investments in the sector.

In March-April 2011, Ukrainian authorities revealed plans to facilitate the introduction of a full-fledged agricultural land market in Ukraine at the beginning of 2012.[10] Restrictions on land ownership are often cited as one of the main impediments for the development of Ukraine's agricultural sector. Hence, the abolishment of the moratorium is in principle a desirable step. However, the abolishment bears a number of risks for the sector as well as for the entire economy (since agriculture accounts for 7.5% of GDP). Development of a good, comprehensive legislative framework is the first step for the reform to be successful. During March, the draft laws "On State Land Cadastre" and "On the Land Market" were registered in the parliament. However, policy makers still cannot agree on a number of key reform issues: land ownership by foreigners, the maximum amount of hectares in single hands, delimitation of land parcel boundaries and ensuring their accessibility, setting a minimum price per hectare and the mechanism of defining the minimum price, timing of the reform, small farms support, etc. In addition, improvement of the land cadastre to a well-functioning, nationwide database will require much time and financial resources. Hence, hasty introduction of the reform may destabilize the sector and cause social tension in the country.

Fiscal Policy

According to Ministry of Finance data, Ukraine's state budget deficit stood at UAH 0.9 billion in 1Q 2011, or less than 0.1% of full-year GDP. Favorable budget balance performance was achieved thanks to robust revenue growth and a moderate increase in expenditures over the period. However, despite good first quarter results, narrowing the broad budget deficit to the targeted 3.5% of GDP in 2011 may be quite challenging.

Over the first quarter of 2011, state budget revenues grew by a solid 28.4% yoy in nominal terms, led by a 50.3% yoy increase in tax receipts. The rise in tax proceeds may be attributed to continuing revival of economic activity and improving profitability of Ukraine's enterprises. In addition, a broader tax base due to restricted use of the simplified taxation system, higher excise duties and royalty taxes and buoyant imports also contributed. At the same time, despite evident improvements in tax collections, such a remarkable growth should be treated with some caution. Thus, 23.5% yoy growth in corporate profit tax (EPT) proceeds in 1Q 2011 to a notable extent reflects the impact of a technical change in the corporate tax reporting period[11]. In addition, total tax revenue growth may

[6] The composite index of production costs in agriculture grew by 22.6% yoy in 1Q 2011, according to the State Statistics Committee of Ukraine.
[7] Capital investments into the agricultural sector grew by 16.5% yoy in 2010, as reported by the State Statistics Committee of Ukraine.
[8] Draft Laws #8053 and #8163 were registered in the parliament in February 2011 and were heavily criticized by both the domestic and international community as they envisaged a creation of a state agent, who would have either a monopoly right to export 'socially important agricultural goods' or would have significant privileges compared to private traders. The bills have not been considered by the parliament so far, with the former being withdrawn in April.
[9] At the end of April 2011, the President vetoed the Draft Law #8324 "On Amendments to Selected Laws of Ukraine (regarding State Support of Agricultural Development)". The Draft Law, approved at the beginning of April, would have introduced auction sales of grain export quotas. The proposed quota distribution system was criticized for being non-compliant with WTO agreement provisions. In addition, at the end of April, the government abolished quotas for corn exports.
[10] A moratorium on the sale of agricultural land was set in January 2010 and expires at the beginning of 2012.
[11] Due to the existence of an additional reporting period for 11 months profits, in February 2010, taxes were paid only on profits received in December 2009. This rule was abolished in 2010. Hence, in February 2011 private enterprises paid their corporate profit taxes on profits earned during the whole 4Q 2010. Due to a low base of comparison, EPT receipts picked up by almost 75% yoy in January-February. The deceleration to 23.5% yoy in 1Q 2011 may be explained by large advance tax payments during the respective period last year.

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be misleading amid modernization of classification of budget revenues on tax and non-tax proceeds (e.g., receipts from royalties, previously classified as non-tax, were moved to the tax revenue category). Given full enforcement of the new Tax Code on April 1st, a corporate tax rate cut to 23%, tax holidays for small business, and a three-month reduction of excise duties on gasoline products, the growth in tax revenues may slow down in the coming months.

State Budget Execution in January-March 2011

	UAH billion	% yoy	General fund execution*
Total Revenues	**66.4**	**28.4**	**1**
Total taxes	57.3	50.3	-
PIT	1.3	-	-10.6
EPT	11.4	23.5	0.6
VAT	29.3	37.9	3.7
Excise taxes. total	6.7	30	-17.7
Duties	2.1	46.4	6.5
Non-tax revenues	8.4	-26.1	
Total Expenditures	**66.7**	**16.2**	**-5.4**
State Budget Balance	**-0.9**	**-**	**-58.5**
New public debt borrowings	23.6	19	-
Public debt principal payments	15.3	290.8	-
Privatization receipts	1.1	8 times	11 times

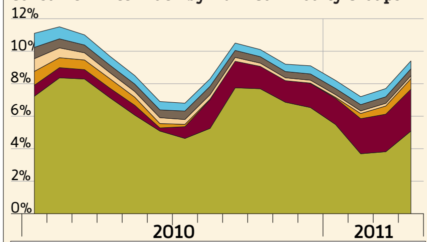
** % of the planned amount.*
Source: Ministry of Finance, 2011 Budget Law, Accounting Chamber of Ukraine The Bleyzer Foundation

State budget expenditures grew by 16.2% yoy in 1Q 2011, up from about 13% yoy in the first two months of the year. Encouraged by robust growth in budget revenues, the government plans wage increases for public sector employees. In addition, delays in pension reform and natural gas tariffs increases to the population are likely to cause higher than initially planned pension fund and Naftogaz deficits. Information about the Naftogaz financial stance is rather limited. In March 2011, the government issued UAH 8.5 billion (about $1.1 billion, or about 0.7% of forecasted full-year GDP) of domestic debt securities to inject Naftogaz with capital. While this amount goes in line with IMF requirements, the actual Naftogaz deficit may be higher amid soaring world energy prices and slower adjustment of utility tariffs. Thanks to robust real wage growth and enforcement of the Law "On the Single Contribution for Comprehensive State Social Insurance" since the beginning of 2011[12], revenues to the Pension Fund of Ukraine grew by a nominal 22.8% yoy in 1Q 2011. At the same time, government transfers to the Pension Fund also grew by 18.2% yoy for the period. Officially, the Pension Fund deficit was reported at UAH 4.4 billion for January-March 2011. However, the actual deficit stood at about UAH 10 billion (about 55% of the annual target) with the difference covered through loans from the Unified Treasury account. The government plans to maintain a broad fiscal deficit at the targeted 3.5% of GDP in 2011. However, given the above developments, the target looks very difficult to achieve. At the same time, the failure to meet the target may put the IMF program in jeopardy.

Monetary Policy

In April 2011, the consumer price index advanced by 1.3% month-over month (mom), bringing 4-month inflation to 4.7%. In annual terms, inflation accelerated to 9.4% in April, up from 7.7% yoy a month before, following faster price growth in the weightiest commodity groups – food, beverages and tobacco, utility services, fuel and transportation services. The biggest monthly price increases were seen in fuel, urban and city transportation services. Despite government efforts to control prices (by setting maximum prices), domestic gasoline prices added almost 5% mom in April, pressured by soaring world crude oil prices and higher excises. In annual terms, the fuel index hit almost 27% in April. Correspondingly, transportation costs started to gain momentum, accelerating to 12.2% yoy in April. As high transportation costs will be eventually passed on to the consumers, they may cause the inflation rate to spike. To contain inflation pressures, the government decided to cut excise duties on gasoline products for the second quarter of 2011. However, being a temporary action, it may have a limited impact on consumer inflation[13] but is likely to bear significant cost to the budget.

Consumer Price Index by Main Commodity Groups



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Rising inflationary pressures and falling population support of government economic policy were likely the main reasons for a delay in natural gas price increases to the population. During the last IMF visit to Ukraine, the government negotiated a more gradual schedule of natural gas tariffs adjustment – 20% in mid-April and another 10% in July. However, the increase was postponed, with the lack of agreement with trade unions used as the official reason for the delay. According to the presidential reform program announced at the end of April 2011, the natural gas tariffs increase to the population will now be decided in November this year. At the same time, adjustment of natural gas tariffs remains one of the key IMF requirements and Ukraine's failure to comply may further complicate negotiations with the Fund on program continuation. Although gas prices to households were left unchanged, the cost of utility services went up by 1.7% mom in April mainly on account of a 15% mom increase in electricity bills.

Food prices climbed 1.6% mom in April following a 1.8% mom increase in the previous month, signaling that the impact of price regulations may have begun to subside. In annual terms, the food price index remains at a rather moderate 7.9%. At the same time, alternative estimates show much higher price growth for selected food products. Thus, according to the State Statistics Committee

[12] The law replaced contributions to the Pension Fund and three Social Security Funds of Ukraine (Unemployment, Disability and Accident Insurance fund) by a single tax. At the same time, private entrepreneurs were required to pay a single contribution based on the statutory minimum wage.

[13] The effectiveness of a temporary cut in excise taxes in containing inflation remains questionable.

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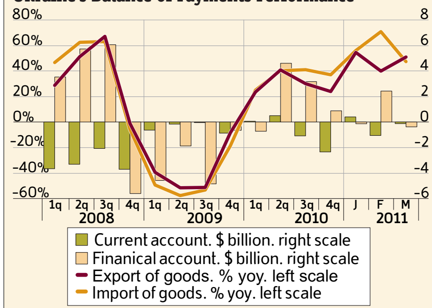
of Ukraine, prices on fruits and vegetables grew by 13.4% yoy and 18.5% yoy in April respectively. At the same time, alternative sources[14] reported the cost of fruits and vegetables were more than 70% higher in April 2011 compared to the respective period last year. The very large divergence between the indices may be partially explained by differences in the methodologies; however, it gives reason to believe that official inflation is notably underestimated. Despite slower than expected utility price adjustments, good harvest prospects and administrative price regulations, we maintain our year-end inflation forecast at about 12% in 2011.

High liquidity in the banking sector and gradually resuming credit activity may also contribute to inflationary pressures this year. Banking sector liquidity is remaining at high levels thanks to continuing robust growth in deposits (up by about 29% yoy in April), large public debt repayments and positive net NBU interventions on the interbank exchange market. Indeed, thanks to a number of successful external quasi-sovereign and private debt placements, net NBU purchases of foreign currency amounted to $1.1 billion in April. As a result, the central bank had to absorb about UAH 37.7 billion ($4.7 billion) of extra liquidity from the market in April to contain additional pressures on inflation. Despite the second largest monthly sterilization operations, banking sector liquidity stayed ample as the central bank wants to facilitate credit growth to support economic activity in the country. Although commercial banks are still in the process of cleaning up their balance sheets from non-performing loans (NPLs) and credit risks remain high, a relatively prolonged period of excess liquidity in the sector prompted the banks to more actively engage in credit activity. The stock of bank loans grew by almost 8% yoy in April 2011. However, NBU deposit certificates are very short-term and costly instruments of controlling banking sector liquidity. Given that the NBU prepares to liberalize the foreign currency market, high banking sector liquidity may result in greater foreign exchange volatility. Despite a good record over the last year and a half, Ukraine's Hryvnia still looks vulnerable.

International Trade and Capital

In March 2011, Ukraine's trade deficit in goods narrowed to $0.9 billion thanks to faster export growth and deceleration of imports. Favorable world steel, iron ore and fertilizer prices and Russia's strong demand for Ukraine's heavy transport vehicles more than compensated for weaker demand from the MENA region. Continuing US Dollar depreciation with respect to other world currencies was also supportive of Ukraine's exports as most prices on exported commodities are set in US Dollars. As a result, the value of goods exports was up by almost 51% yoy in March, up from about 40% yoy in the previous month. At the same time, the growth of imports lost speed, advancing by 47.3% yoy in March, down from almost 71% yoy a month before. Moderation of import growth is primarily attributed to slower growth in energy imports. A natural gas price discount for Ukraine's chemical industry and lower volumes of natural gas imports may explain the deceleration in the value of imports of the weightiest commodity group. Weaker demand from Ukraine's industrial sector (metallurgy, in particular) and a growing statistical base also affected the speed of import growth. Thanks to an improved trade balance and larger workers' remittances from abroad, the current account deficit narrowed to $0.1 billion in March compared to a $1.1 billion deficit in February.

Ukraine's Balance of Payments Performance



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

In contrast, Ukraine's capital and financial account balance switched to a $0.4 billion deficit in March, compared to a $2.4 billion surplus a month before. Large external debt repayments (both private and sovereign), lower FDI inflows to the country and high population demand for foreign currency were the main reason for the deterioration. The situation should notably improve in April-May given the number of Eurobonds issues carried out that month ($0.5 billion by iron ore mining company Ferrexpo, $0.7 billion by the National Agency on Preparation and Holding Euro 2012 Football Championship, and $0.3 billion by agricultural company Mriya to name the few) and successful privatization of Ukrtelecom, the fixed-line telecommunication monopoly, for $1.3 billion.[15] April's development of the NBU gross international reserves, which were augmented to a record high $38.4 billion at the end of the month, confirms that view.

Unlike the first half of the year, for which a high capital and financial account surplus is likely to be recorded, external sector performance in the second half of the year may be quite challenging. First, Ukraine's current account performance may further worsen as the average price of natural gas imports under the current formula may be more than 25% higher than in 1H 2011 and imports tend to accelerate in the fall. Second, the near term prospects of Ukraine's co-operation with the IMF are unclear as Ukraine failed to comply with a number of key conditions. The Ukrainian authorities hope to negotiate a relaxation of the IMF program requirements during the next IMF visit to Ukraine considering the previous flexibility of the IMF conditionality. At the same time, the IMF has already compromised on deadline extensions for natural gas tariffs adjustment to the population and pension reform during previous IMF visit to Ukraine in February 2011. However, the program disbursement was delayed in view of pending compensatory measures to sustain Naftogaz finances and keep a broad fiscal deficit targeted at 3.5% of GDP in 2011. There is little information about whether the measures were developed and discussed with the IMF. Given weaker policy implementation, the IMF staff visit, previously scheduled for mid-May 2011, was delayed. Uncertainty with the next IMF tranche disbursement may adversely affect investors' confidence, necessary to maintain Ukraine's external debt rollover ratio high. Therefore, Ukraine's foreign exchange market may face higher depreciation pressures in the second half of the year.

[14] Fruit and vegetable price index by APK-inform; price monitoring by private newspapers and institutions.
[15] The agreement was signed in mid-March 2011; however, the payment was made in several tranches during April-May.

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