Ukraine
Macroeconomic Situation

June 2011

Olga Pogarska, Edilberto L. Segura

- **Industrial production growth rebounded at 8.6% yoy in May 2011.**
- **The state budget deficit for the first five months of the year narrowed to UAH 1.6 billion thanks to higher growth of revenues, which notably outpaced expenditures.**
- **The state budget deficit target was revised downwards to 2.7% of GDP. Given higher Naftogaz imbalances, this will allow for maintaining the broad fiscal deficit at 3.5% of GDP, in line with IMF requirements.**
- **At the beginning of July, the Ukrainian parliament passed the pension reform bill, which raises the likelihood of unfreezing the IMF loan program to Ukraine during the next few months.**
- **Although seasonal factors brought some relief to domestic prices in May-June, in annual terms consumer inflation surged to 11.9% yoy in June.**
- **Acceleration in inflation prompted the National Bank of Ukraine to enter a monetary tightening cycle.**
- **The current account deficit widened to $2.3 billion amid a more challenging external environment for Ukraine's exports and surging imports.**

Executive Summary

In May 2011, the Ukraine economy started regaining its footing from March-April weaknesses. Industrial production growth picked up to 8.6% yoy from 4.9% yoy in April. Expansion in retail trade and construction accelerated to 15.5% yoy and 13.2% yoy, respectively, over the first five months of the year. These improvements signal a growing contribution of domestic consumption and investments to real GDP growth in 2Q 2011. At the same time, a rapidly widening current account deficit will exact a toll on economic growth. Hence, despite a strong real GDP increase of 5.3% yoy in the first quarter of the year, our real GDP growth forecast remains unchanged at 4.5% yoy for 2011.

Solid economic growth, the rising profitability of Ukrainian enterprises and a broader tax base resulted in better than expected budget revenue growth in January-May 2011, while a rise in budget expenditures lost speed due to a higher base for comparison. As a result, the state budget deficit narrowed to UAH 1.6 billion (about $0.2 billion) over January-May. Better than expected budget performance prompted the Ukrainian authorities to amend the 2011 budget law. Despite an envisaged faster increase in government spending, the year-end state budget deficit target was reduced to 2.7% of GDP. Given the higher Naftogaz deficit, this would help keep the broad fiscal deficit at 3.5% of GDP, in line with IMF requirements.

At the beginning of June, the Ukrainian authorities showed a firm determination to revive the IMF program by submitting a revised pension reform bill to the parliament. While the new version of the bill maintains the most painful and highly unpopular measures of raising the pension age for women and capping maximum pension benefits, the reform was passed by the parliament at the beginning of July. The approval of a pension reform bill increases the likelihood of IMF program resumption in the coming months despite unclear prospects for natural gas price increases to the population.

Thanks to a seasonal increase in the supply of fruits and vegetables, a reduction in excise taxes and a delay in utility tariffs adjustment, monthly consumer price growth eased to 0.4% in June. However, due to a low statistical base, consumer inflation accelerated to 11.9% yoy that month. The speed-up in annual rates of consumer price index growth and intensified Hryvnia foreign exchange pressures since mid-May prompted the National Bank of Ukraine to begin monetary policy tightening. In mid-June, the NBU announced an increase in reserve requirements for commercial banks beginning July 1st, raised interest rates on its certificate of deposits and tightened regulation of banks' open foreign currency position (the difference between foreign currency assets and liabilities). These measures are forecast to reduce Hryvnia liquidity and increase supply of foreign currency, which may cause moderate appreciation pressures on the Hryvnia in the short-term.

	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	36.0
Current account balance, % GDP	-1.5	-3.7	-7.0	-1.7	-1.9	-3.9
Gross external debt, % GDP	50.6	56.0	56.4	88.6	88.1	80.0
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

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Economic Growth

Real sector performance improved in May 2011, led by buoyant domestic consumption, strong investment activity and a favorable statistical base effect. Despite rising inflation, consumer spending was supported by a steady growth in real wages (up by 9.6% yoy over January-May 2011) and reviving consumer credit (12-month cumulative flow of bank credit to households grew by almost 8% yoy in May 2011). Thus, retail sales turnover, a close reflector of consumer demand trends, expanded by 15.5% yoy in January-May 2011. Growing consumption gave boost to domestic market oriented light industry (up by 14.7% yoy in May), non-financial services (up by 17.8% yoy over January-May 2011) and food processing. Output the food industry in May 2011 was virtually the same as in May of last year (-0.1% yoy) amid further gains in meat, fruit and vegetable processing, although cumulative terms food and tobacco output fell by 2% yoy for January-May 2011.

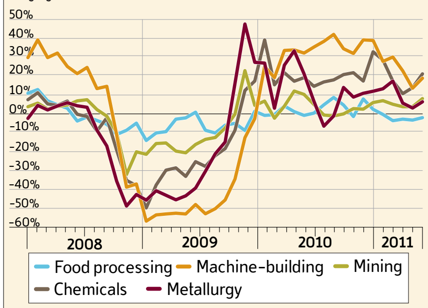
Real Sector Performance of Ukraine
% yoy

	Jan-May 2011	Jan-May 2010	2010	2009	2008
Agricultural output	3.5	4.5	-1	-1.8	17.1
Industrial output	8.5	12.6	11	-21.9	-3.1
Construction works	13.2	-20.0	-5.4	-48.2	-15.8
Domestic trade turnover					
Wholesale trade	0.8	4.7	0.4	-19.3	-6
Retail trade	15.5	1.1	7.6	-17.4	18.1
Restaurants	13	-0.5	3.5	-15.6	4.6
Transportation turnover					
Cargo	8.9	13.8	6.4	-22.5	-0.2
Passenger	3.4	-3.7	-0.2	-11.5	4.5
Services, non-financial	17.8	-2.3	2.9	-16.8	15.8

Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Backed by good budget financing of infrastructure projects and reviving bank credit, construction works grew by a real 13.2% yoy over January-May 2011, further up from the 11.6% yoy registered in the first four months of the year. Elevated world fertilizer prices and stronger demand from the domestic agricultural sector underpinned an acceleration of production of chemicals to 21% yoy in May. In addition, following a 20% yoy decline over January-April 2011, production of refined petroleum surged by 11.6% yoy in May 2011. Given also strong mining and utility industries, the overall industrial sector expanded by 8.6% yoy in May, a notable acceleration compared to the less than 5% yoy increase reported in April. However, despite stronger figures in May, a deeper data reading reveals that the industrial sector faces significant challenges.

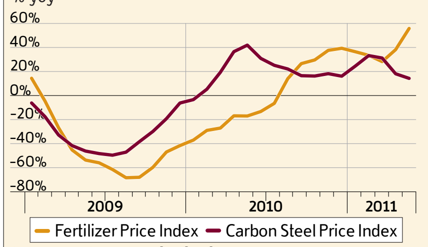
Industrial Production Growth by Select Branches
% yoy



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

First, Ukraine's metallurgy, accounting for about 25% of total industrial production and almost 40% of merchandise exports, grew at a moderate 6.4% yoy in May. Although this was a clear acceleration from 3.1% yoy growth a month before, May's rebound may to a large extent be attributed to a more favorable statistical base effect. While this effect will remain strong in subsequent months, a more challenging external environment[1] may exact a toll on the industry's performance.

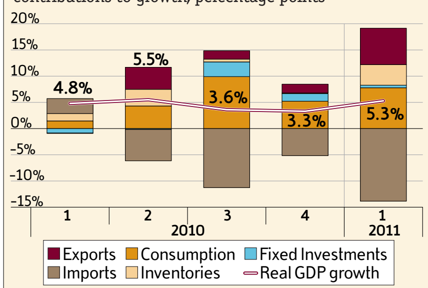
World Steel and Fertilizer Price Indices
% yoy



Source: MEPS, WB GEM databank

Second, moderation of investment demand in Russia, the main destination market for Ukraine's export of heavy machinery, and rising uncertainty over economic relations between the countries[2] may explain the rather volatile industrial performance during April-May 2011 (following a 27% yoy increase in output in 1Q 2011, output growth eased to 13.6% yoy in April but recovered to 19% yoy in May).

Real GDP Growth by Demand Component
contributions to growth, percentage points



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Third, May's rebound in selected industries was partially caused by short-term forces. The surge in oil-refining production in May may be attributed to realization of government measures to curb soaring fuel prices, although a low statistical base effect also played a notable role. At the beginning of the year, the government introduced price caps on petroleum products. However, as this approach proved to be generally unsuccessful, the government decided to undertake petroleum sale interventions on the domestic fuel market. In May 2011, Naftogaz Ukrainy, the national oil and gas monopoly, started Russian crude oil processing at Lisichansk refinery. While this helped improve the industry's performance that month, higher purchase prices of crude oil amid low depth of oil refining in Ukraine made domestically produced fuel more expensive relative to foreign gasoline. Correspondingly, Naftogaz fuel sale auctions were of little success, indicating that the increase in domestic oil refining may be short-lived.

[1] MENA region political turbulence, supply disruptions following Japan's earthquake, new momentum in the European sovereign debt crisis, and new tightening concerns in China intensified downside risks for global economic growth. High market uncertainties are likely to pressure world commodity prices downwards.

[2] In March-April 2011, Ukraine was urged by Russia to join the Customs Union (Russia, Belarus and Kazakhstan). Furthermore, the Russian prime minister expressed warnings that Russia may impose trade barriers with Ukraine in case a free trade area with the EU is created. Being in the final stage of talks on the creation of a free trade area with the EU, Ukraine seems determined to complete negotiations by the end of 2011, which may mean worse trade opportunities for Ukraine's heavy machinery industry.

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Finally, there were continuing weaknesses in production of dairy, flour-milling and bread products, related to supply shortages of raw materials. Indeed, production of milk kept deteriorating, falling by 2.1% yoy over the first five months of 2011. Continuing reduction in the cattle stock and raw milk production was likely the main reason for agricultural output deceleration to 3.5% yoy in January-May 2011 (from 4% yoy in the first four months of the year). The sector, however, may improve performance in the summer months amid good prospects for this year's harvest. Although heavy rains in late June/early July may reduce yields of winter grain, they may have a positive impact on spring crop yields, particularly corn and sunflower. Therefore, although the wheat harvest is likely to be lower than initially projected, the Ukrainian Agricultural Policy and Food Ministry maintained its total grain harvest estimate at about 45 million tons, which would be 14.5% higher than last year.

Overall, although Ukraine's real sector demonstrated further improvement in May, industrial sector weaknesses, stemming from a high dependence on the external environment, uneven domestic reform progress and surging imports indicate that the growth remains fragile. Thus, according to detailed first quarter national accounts data, real GDP grew by 5.3% in 1Q 2011. One of the highest growth rates in the region was achieved thanks to a 12.7% yoy increase in private consumption, buoyant exports (up by 19% yoy in real terms) and very strong inventory rebuilding. Gross capital accumulation (which includes changes in the stock of inventories) advanced by 61.4% yoy over the period. At the same time, rising domestic consumption and inventory growth triggered a 39.3% yoy surge in imports.

Although the pace of import growth is likely to ease with projected lower volumes of natural gas imports in the second half of the year, strong domestic demand will keep imports growing fast. At the same time, the new wave of concerns over the pace of global economic growth has already started to affect Ukraine's export strength. Although higher export of agricultural products following an abolishment of grain export quotas in May 2011 and good harvest prospects will support export performance, negative net export contribution to GDP growth is expected to further increase, dragging down economic growth. In addition, the first quarter increase in fixed investments by 4.5% yoy was rather disappointing compared to the roughly 11% yoy increase in the second half of 2010. Uneven progress with structural reforms, growing perceptions of a more complicated business environment in Ukraine and still subdued credit growth restrain investment activity. For these reasons, while the economic growth outlook remains generally favorable for Ukraine, we project growth moderation through the rest of the year with full-year real GDP growing by 4.5% yoy.

Fiscal Policy

May's fiscal data revealed further improvements in Ukraine's public finances. Solid economic growth, the rising profitability of Ukrainian enterprises and a broader tax base underpinned a 27% yoy increase in budget revenues over the first five months of the year. In particular, proceeds from the corporate profit tax were 57% in January-May 2011 compared to the same period last year. Thanks to robust domestic demand, collections from VAT and import duties were 30.5% yoy and 38.2% yoy higher in nominal terms over the period. Excises were the only taxes reporting growth deceleration, following a temporary reduction in excise tax rates on fuels.

State Budget Execution in 2011

	UAH billion	% yoy	
Total Revenues	**119**	**26.9**	**20.9**
Total taxes	102.2	51.2	44.2
EPT	23	56.9	20.8
VAT	50.2	30.5	29.7
Excise taxes, total	11.9	18.7	25.4
Duties	3.7	38.2	41.5
Non-tax revenues	15.4	-31.2	-31.9
Total Expenditures*	119.6	8.9	18.6
State Budget Balance	**-1.6**	**9.5 times lower**	**5.5**
New public debt borrowings	39.4	47.6	54.5
Public debt principal payments	21.4	2.1 times higher	2.5 times higher
Privatization receipts	10.9	-	-

*Excluding net lending from the budget
Source: Ministry of Finance, The Bleyzer Foundation

In contrast to budget revenues, the growth in budget expenditures slowed from 18.6% yoy in January-April 2011 to less than 9% yoy in January-May. Such a notable deceleration may be mainly attributed to slower growth in budget social security expenditures. Thanks to buoyant growth in nominal wages (up by 19.3% yoy over the first five months of 2011) and a broader taxation base (in mid-2010, private entrepreneurs on a simplified taxation system were obliged to pay pension fund contributions based on a statutory minimum wage), own Pension fund revenues grew by 22.3% yoy over the period. At the same time, following the approval of a 2010 budget law in late-April of last year, social expenditures, and thus state budget transfers to the pension fund, notably increased in May,[3] creating a high base for this year's comparison. A combination of these two factors explains the slowdown in budget spending on social security to 10.2% yoy in January-May compared to a 24.1% yoy increase in the first four months of 2011. With the budget revenue pace of growth notably exceeding that of expenditures, the state budget deficit narrowed to UAH 1.6 billion (about $0.2 billion) over January-May.

Budget revenues may lose speed in the second half of the year amid a corporate tax rate reduction, implementation of other tax holidays for small businesses and approval of a simplified taxation system. However, better than expected fiscal performance over the first five

[3]According to Ministry of Finance data, pension expenditures from the state budget amounted to UAH 15.1 billion in May 2010 alone, virtually equal to the amount spent during the first four months of 2010. In particular, state budget transfers to cover the Pension Fund deficit for January-May 2010 were almost 3.5 times higher than in January-April 2010.

months prompted the government to amend the state budget law, allowing for faster budget expenditure growth (9.7% yoy instead of the previous 5.6% yoy) in 2011. At the same time, upward revision of budget revenues to incorporate faster real GDP and price growth helped narrow the state budget deficit target to 2.7% of GDP, down from the previous 3% of GDP. In view of the higher Naftogaz deficit, due to a delay in natural gas tariff adjustment to the population and surging energy prices, this would allow Ukraine to keep the broad fiscal deficit target at the IMF-required 3.5% of GDP.

June's Amendments to 2011 State Budget Law

	Previous target	Current target	% change to prev, target	% change to 2010
Revenues, UAH billion	285.1	299.1	4.9	24.4
Expenditures*, UAH billion	322.4	334.5	3.7	9.7
Balance, UAH billion	-37.4	-35.3		
% of GDP	**-3**	**-2.7**		
Real GDP growth, %	4.5	4.7		
GDP deflator, %	9.5	12.6		
CPI, eop, %	8.9	8.9		

**Including net lending from the budget*

Source: 2011 State Budget Law, The Bleyzer Foundation

Ukraine's Progress with Key IMF Criteria

	Criteria	Progress
1	Natural gas tariffs increase to the population	still pending
2	Budget compensatory measures to keep the broad budget deficit at 3.5% of GDP	2011 budget law amended in June
3	Pension reform	approved on July 8th
4	Liberalization of domestic currency market and ensuring NBU independence by eliminating a requirement for the NBU to purchase domestic government securities issued for recapitalization purposes in three days upon request	accomplished in May-June

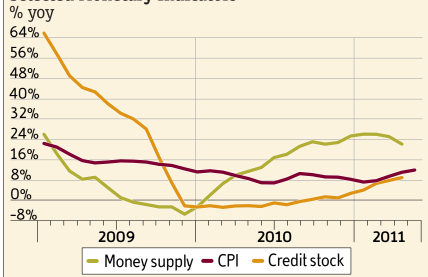
Recently, the Ukrainian authorities expedited the approval of pension reform, signaling their firm determination to revive the IMF program. Thus, at the beginning of June, the government submitted a revised version of the pension reform bill, which still preserved the most sensitive clauses of gradually raising the pension age for women to 60 years (from the current 55 years) and male civil servants to 62 years (from 60 years), increasing the qualification period from 25 to 30 years for women and from 25 to 35 years for men, lifting the minimum insurance period from 5 to 15 years and capping maximum pension benefits to 10 living wages (currently UAH 7600, or about $950). Despite public protests, the reform was finally approved on July 8th. Proposed reform measures are likely to bring relatively moderate improvements to the Pension Fund situation in the short-term as the pension age will be raised very gradually and restrictions on maximum pensions will likely be applied only to new pensioners. However, the law envisages introduction of a second pillar of pension system in the medium-term, which should ease the financial burden of Ukraine's social security system on public finances and spur domestic capital market development.

Hiking natural gas tariffs to population and pension reform were the most critical requirements to revive the IMF loan program to Ukraine, which had stalled since March 2011. Although the prospects of tariff increases to the population remain unclear as the government announced that natural gas prices to the population will not be raised in 2011, the approval of a pension reform bill notably increases the likelihood of IMF program resumption in the coming months.

Monetary Policy

As anticipated, a delay in utility tariffs adjustment, a temporary reduction in excise taxes, a seasonal increase in the supply of fruits and vegetables, and easing international energy prices brought some relief to domestic prices in May and June. In monthly terms, consumer price growth moderated to 0.8% mom in May and to 0.4% mom in June compared to average monthly growth of 1.2% over the first four months of the year. In annual terms, however, inflation reached 11.9% yoy in June due to a low statistical base in the previous year. Projected good agricultural harvest this year will help to further reduce food price pressures. However, an unfavorable base for, a reversal of higher excise taxes, likely supply shortages on selected food markets (i.e., raw milk), and buoyant consumption will keep consumer inflation at double digits in the second half of the year. We forecast consumer prices to increase by 12% yoy in 2011, well above the official forecast of 8.9%.[4]

Selected Monetary Indicators



Source: State Statistics Committee, NBU, The Bleyzer Foundation

Given that inflation is mainly driven by supply factors, until recently the NBU efforts were mainly concentrated on maintaining foreign exchange market stability and stimulating the still sluggish bank credit activity. Acceleration of inflation during May-June prompted the National Bank of Ukraine to start tightening monetary policy.

Due to the balance of payments surplus in January-May 2011, net NBU purchases of foreign currency amounted to $1.7 billion over the period. Forex interventions helped keep the Hryvnia exchange rate virtually stable over the period (the official Hryvnia exchange rate with respect to the US Dollar depreciated by 0.1% been January and June 2011) and augmenting NBU gross international reserves to $37.9 billion as of the end of May 2011. At the same time, large purchases of foreign currency, repayments on domestic debt securities and robust deposit growth (up by 25.2% yoy in May 2011) resulted in ample liquidity in the banking sector. However, the growth of banks' credit allocation was at a moderate 9% yoy in January-May as commercial banks kept struggling with a high share of non-performing loans. This as well as perceived real sector high credit risk is reflected in high bank lending rates, which in turn discourage credit demand. To absorb excess liquidity from the market, the NBU has actively used its deposit certificate (CDs) facility.

[4]In June, the government revised its forecast for the main macroeconomic indicators for 2011; however, the year-end consumer inflation forecast was kept unchanged. At the same time, the national bank predicts consumer inflation to be in the range of 10%±1% in 2011.

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However, despite sizable sterilization operations, banking sector liquidity remained high, adding to inflationary pressures and potentially engendering higher exchange rate volatility.

Monetary Policy Tightening Measures*

Mandatory reserve requirements

Term deposits			Current accounts and demand deposits		Deposits from non-residents		Portion of 2012 football bonds allowed to be included in reserves
in Hryvnia	in Foreign currency		in Hryvnia	in Foreign currency	in Hryvnia	in Foreign currency	
	ST	LT					
0%	6% (4%)	2% (4%)	0%	8% (7%)	0%	2%	50% (100%)

Interest rates on NBU's certificates of deposits

Maturity	14 days	1 month	1.5 months	3 months
Interest rate	3.3% (2.5%)	4% (3%)	5% (3.5%)	6,80%

Open foreign exchange position requirements: 5% (20%) of regulatory capital

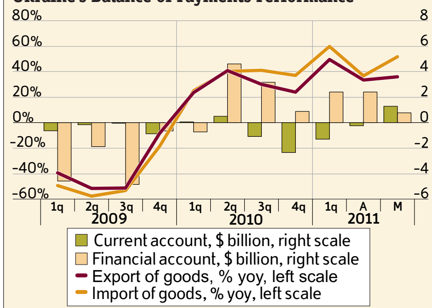
Previous requirements are shown in parentheses.
Source: NBU, The Bleyzer Foundation

Indeed, during May-June 2011, the Hryvnia turned out to be under significant depreciation pressures amid a widening current account deficit, high external debt repayments and strong population demand for cash foreign exchange. Thus, according to NBU representatives, the central bank had to sell about $1.2 billion to calm the foreign exchange market in the second half of May. To rein in inflation and to counter the recently intensified Hryvnia depreciation pressures, the NBU entered a tightening mode. In particular, since July 1st, the NBU raised mandatory reserve requirements and narrowed banks' ability to use domestic securities (issued to finance Euro-2012 football championship projects) to meet reserve requirements. In mid-June, the National Bank also raised its CD rates and started offering 3-month CDs. Furthermore, at the end of June, the NBU tightened its regulation of banks' open foreign currency positions (the difference between foreign currency assets and liabilities) to 5% of regulatory capital from the previous 20%. These measures are forecast to reduce Hryvnia liquidity as well as to increase supply of foreign currency in the short term. At the same time, new restrictions on open foreign currency positions may increase commercial banks exposure to foreign exchange risks.

International Trade and Capital

Slowing world economic growth in 2Q 2011 and a lull in world steel price growth weighed on Ukraine's exports. Export growth of metallurgical products continued to lose momentum, decelerating to 20.8% yoy in May, down from a 30.1% yoy increase in April. Amid easing investment demand in Russia, the main outlet for Ukraine's heavy machinery, the growth of Ukraine's exports of machinery and equipment moderated to 31% yoy in May, down from a roughly 41% yoy increase over January-April 2011. However, thanks to elimination of export quotas on corn and elevated word grain prices, total exports of goods remained strong in May 2011, advancing by almost 36% yoy. Indeed, exports of food and agricultural products surged by 54% yoy in May compared to less than a 10% increase in the previous month. High world fertilizer and fossil fuel prices supported a 43.6% yoy and 69.5% yoy growth in exports of chemical and mineral products respectively.

Ukraine's Balance of Payments Performance



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

On the import side, imports rose by 51.7% yoy in May, led by higher energy imports (+57% yoy) and a 90.7% yoy surge in transport vehicle and other machinery imports. Given imports rising at a much faster pace than exports, Ukraine's trade deficit in goods kept widening in May, bringing the five-month deficit to $4.6 billion, 2.5 times higher than in the respective period last year. Amid a worsening trade balance and higher dividend payments abroad, the current account deficit widened to $0.7 billion in May, with the cumulative deficit reaching $2.3 billion over January-May. Robust domestic demand and higher energy prices suggest that the current account deficit will continue to widen through the rest of the year, likely exceeding 3% of GDP already this year.

So far, high capital and financial account surplus more than covered the growing current account deficit, allowing the NBU to augment its gross international reserves to $37.9 billion as of the end of May. However, securing sufficient financing to cover a widening current account, meet external debt liabilities and satisfy high population demand for foreign currency may become increasingly challenging in the second half of the year. For the first five months of the year, financial account surpluses were achieved mainly on account of sizable sovereign and quasi-sovereign external public sector borrowings and Ukrtelecom privatization proceeds. By excluding Ukrtelecom receipts, net FDI inflow for the period turns out to be lower than in the corresponding period last. The banking sector remains a net capital exporter this year amid lower external debt roll-over (70% for the first five months of 2011 compared to 82% a year ago). Excluding corporate sector indebtedness on supply of goods (trade credits) and quasi-sovereign Eurobonds issued to finance Euro-2012 projects, the corporate sector would also show small but capital outflow over January-May 2011. Although the current level of gross international reserves will allow the country to manage its external financing requirements even without the IMF program, the resumption of the IMF program would substantially ease financial pressures on the Ukrainian market and increase the country's resilience to adverse external shocks.

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