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Ukraine Macroeconomic Situation

THE BLEYZER FOUNDATION
Turning Transitions Into Prosperity

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- **The sharp economic growth slowdown in developed economies in 2Q 2011 and the continuing crisis in the EU (with a rising risk of spreading into Spain and Italy) are pointing to weaker global economic growth prospects.**
- **Slower global growth will drive commodity prices down, which will negatively affect commodity exporting countries.**
- **Real GDP growth moderated to 3.8% yoy in 2Q 2011 compared to 5.3% yoy in 1Q 2011. Cumulative growth stood at 4.4% yoy in 1H 2011.**
- **Industrial production grew by 8.9% yoy in June 2011. Despite acceleration from the previous month, the outlook for the sector has deteriorated for the second half of 2011, in line with weaker export prospects.**
- **Real sector data for June and July showed signs of easing domestic consumer demand.**
- **As a result, we have revised Ukraine's GDP growth forecast to 4% yoy in 2011.**
- **State budget performance was better than projected in the first half of 2011. The deficit stood at UAH 10.4 billion (1.7% of estimated period GDP), almost 2.5 times lower than in 1H 2010.**
- **Nevertheless, the broad fiscal deficit target of 3.5% of GDP looks difficult to achieve due to higher Naftogaz imbalances.**
- **Consumer inflation declined to 10.6% yoy in July amid lower food price growth. As international price pressures are expected to ease, Ukraine's inflation forecast for 2011 was revised down to 10-11%.**
- **As anticipated, monetary tightening measures have affected banking sector liquidity and increased the supply of foreign currency. This has helped reduce pressure on the Hryvnia exchange rate in July-August.**
- **With weaker exports in the second half of 2011, strong imports, the high population demand for foreign currency and large external private debt financing needs, the Hryvnia is likely to be under depreciation pressure in the second half of 2011.**
- **However, the current level of international reserves will allow the NBU to keep the Hryvnia exchange rate stable for a while, but over the medium term some depreciation should materialize.**

Executive Summary

Recent financial market turmoil (due to the US debt downgrade and rising risk of a broadening European solvency crisis) and disappointing GDP data in a number of developed economies have weakened global economic growth prospects for the rest of 2011. Slower global economic growth will pressure world commodity prices down, including prices on steel, the principal exporting commodity of Ukraine. In addition, Ukraine's main trading partners are likely to grow at a slower pace due to downward correction in oil prices (Russia), fiscal austerity measures (Italy) and close ties to Eurozone countries (Poland, Turkey). Furthermore, more complicated trade relations with Russia, Ukraine's largest trade partner, may also contribute to Ukraine's export growth slowdown. Weaker external demand and downward pressure on commodity prices will weigh on Ukraine's exports and, thus, economic growth.

According to preliminary estimates, Ukraine's economy grew by 3.8% yoy in 2Q 2011. Thanks to strong 5.3% yoy growth in 1Q 2011, real GDP was up by 4.4% yoy in 1H 2011. Second quarter growth was dragged down primarily by the export-driven industrial sector, which faced a more challenging external environment during the period. Furthermore, sector data for June and July suggests domestic consumption also started to weaken at the end of the quarter. In addition, although industrial sector growth further accelerated in June to 8.9% yoy, up from 8.7% yoy in May, performance across individual branches and sectors was quite uneven with a favorable statistical base effect playing a significant role in the speed up. In the second half of the year, the growth will be supported by a better agricultural harvest, higher social spending from the budget and continuing state investments into infrastructure projects. However, exports account for 50% of Ukraine's GDP and exports prospects recently deteriorated, so we have revised our real GDP growth forecast for Ukraine to 4% yoy in 2011.

Higher than anticipated growth in tax revenues (due to both tax rate increases and general improvement in the economic situation during the first five month of the year) and tighter control over expenditures helped narrow the budget deficit to UAH 10.4 billion over the first half of 2011. Given the first half year developments, the year-end state budget deficit target of 2.7% of GDP looks realistic even considering the higher social spending envisaged by June's budget amendments. At the same time, the broad fiscal deficit target of 3.5% of GDP may be in jeopardy due to higher Naftogaz imbalances. Due to the government reluctance to raise natural gas tariffs to the population and higher than projected average prices for imported natural gas, the Naftogaz deficit may end 2011 with a UAH 15 billion deficit, almost twice as high as initially projected. Measures to sustain Naftogaz's financial situation are also important to resume the IMF program with Ukraine. Cooperation with the IMF looks increasingly important for Ukraine, as it will increase the country's resilience to adverse external shocks.

Thanks to lower food price growth in July, consumer price inflation eased to 10.6% yoy, down from almost 12% yoy in June. With a better agricultural harvest and lower pressure from international commodity prices, domestic prices are forecast to grow at a slower pace than initially projected. However, due to local factors stemming from the reinstatement of higher excises, gasoline supply shortages, more expansionary fiscal policy and a lower base effect, inflation is projected to stay in double digits at about 10-11% yoy at year-end.

The current account deficit narrowed to $0.2 billion in June as the elimination of grain export quotas boosted exports and lower volumes of natural gas imports caused a notable improvement in Ukraine's foreign trade in goods balance. However, the first half cumulative deficit amounted to $2.5 billion in contrast to a $0.6 billion surplus in the corresponding period last year. Now with much weaker export growth prospects for Ukraine in the second half of 2011 and still high energy imports (principally due to the presence of a 9-month lag in the imported natural gas price formula), the current account deficit may reach about 4.5% of GDP this year.

On the financial account side, Ukraine secured a rather high surplus over the first half of 2011. However, it was mainly achieved thanks to sovereign and quasi-sovereign borrowings from abroad. Likely intensified risk aversion due to fears of deepening EU sovereign debt crisis and global economic growth slowdown may adversely affect foreign capital inflows to Ukraine in the second half of the year. Although we do not expect significant capital outflow from the country, Ukrainian banking and the private sector (excluding quasi-government enterprises) may face difficulties in maintaining high roll-over ratios.

In addition, population demand for foreign currency remains unusually high, pressuring the Hryvnia exchange rate. During June-July, net population purchases of foreign currency amounted to $2.1 billion, compared to $0.3 billion in the respective months last year. In June 2011, the NBU sold about $1.5 billion on the interbank market to support the Hryvnia. In July, the NBU interventions were only $0.3 billion thanks to the NBU's monetary tightening measures initiated at the end of June; however, they were still negative. Since the beginning of the year, net purchases of foreign currency exceeded $7 billion. High population demand for foreign currency, a wider current account deficit and large external debt financing needs will pressure the Hryvnia to depreciate. At the same time, the NBU had accumulated $37.8 billion of international reserves by the end of July, which will help mitigate these pressures over the short term. At the same time, due to a loss in competitiveness and weaker exports, the Hryvnia may be allowed to depreciate moderately over the medium term.

	2006	2007	2008	2009	2010	2011f
GDP growth. % yoy	7.3	7.9	2.3	-14.8	4.2	4.0
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	10-11
Gross international reserves. $ billion	22.4	32.5	32.5	26.5	34.5	35.0
Current account balance. % GDP	-1.5	-3.7	-7.0	-1.7	-1.9	-4.5
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	8.0

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

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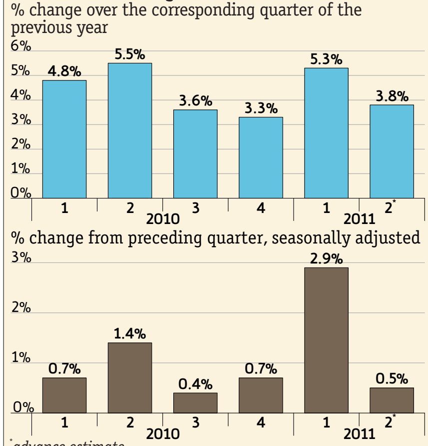
Economic Growth

According to advance estimates of the State Statistics Committee of Ukraine, real GDP growth eased to 3.8% yoy in 2Q 2011 from 5.3% yoy in the preceding quarter. Seasonally adjusted quarterly data also confirms that the Ukrainian economy continued to expand in the second quarter of the year but at a slower pace. The second quarter growth was dragged down primarily by the export-driven industrial sector, which faced a more challenging external environment during the period. Agriculture, affected by weaknesses in cattle breeding, also contributed to the slowdown. Although the industrial sector regained growth momentum in May-June and agriculture is projected to improve in the coming months amid a better-than-expected harvest, the economic growth prospects for Ukraine have recently deteriorated, leading us to revise our real GDP forecast for Ukraine downwards.

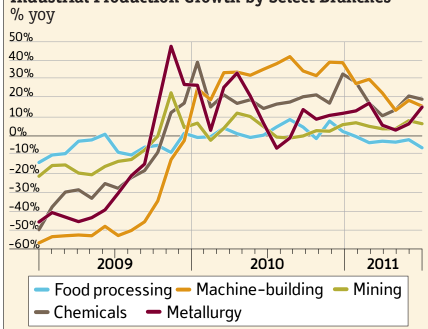
Ukraine's Real GDP growth



*advance estimate
Source: SSC, NBU, The Bleyzer Foundation

In June 2011, industrial production growth accelerated to 8.9% yoy in June, up from 4.9% yoy in April. The six-month cumulative industrial sector growth reached 8.7% yoy. As in the previous month, a favorable base effect played an important role in the sector's recent gains. Thus, though there was a lull in world steel price growth and June's monthly output was lower than in previous months, the growth in metallurgy accelerated to 15.3% yoy in June, up from 6.5% yoy a month before. A similar pattern was also observed in iron ore mining; despite the fact that June's extraction of iron ore was almost 4% lower than in the previous month, in annual terms output production growth accelerated to about 7% yoy compared to only 2% yoy in May. However, as domestic extraction of natural gas and oil kept declining during the first six months of 2011 (due to chronic under-investment into energy extraction infrastructure), total mining industry production growth moderated to 6.5% yoy in June.

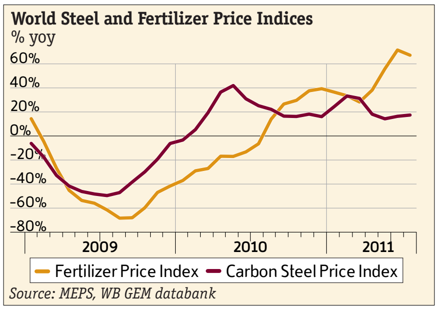
Industrial Production Growth by Select Branches



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

The continuing rally in world fertilizer prices underpinned a 19.5% yoy increase in Ukraine's chemical industry, and machine-building benefited from stronger investment activity in Russia and solid domestic demand, advancing by 16% yoy in June. A 28% yoy surge in Ukraine's production of refined petroleum products in June (compared to a 20% yoy reduction in January-April this year) is explained by a powerful base effect, government efforts to stabilize domestic fuel prices by Naftogaz holding fuel sale auctions and toll processing for Russia at one of the largest Ukraine's oil refinery[1].

World Steel and Fertilizer Price Indices



Source: MEPS, WB GEM databank

Despite recent improvements, the prospects for economic growth in the second half of the year have deteriorated, mainly on account of a weaker export outlook. First, disappointing economic data for 2Q 2011 in a number of developed economies and uncertainties related to sovereign debt problems signal that the global economy will slow in the second half of 2011. This is likely to weigh on world commodity prices, adversely affecting Ukraine's heavily export-oriented industries as well as its closely linked sectors (e.g., cargo transportation, wholesale trade, etc.). Second, foreign demand for Ukraine's exports is likely to weaken due to slower economic growth in the country's main trading partner countries. Declining world commodity prices may be particularly painful for Russia, accounting for 27% of Ukraine's export of goods. In addition, Ukraine may suffer from more complicated trade relations with this country. In mid-July, Russia restricted imports of Ukraine's meat and dairy products and caramel, and introduced anti-dumping duties on imports of Ukrainian pipes. Unlike in previous years, the new restrictions will be automatically imposed by the two other members of the Customs Union – Belarus and Kazakhstan.

Third, due to a 9-month lag for oil prices in the formula for imported Russian natural gas (which Russia is reluctant to change), Ukraine may face a roughly 30% increase in the cost of natural gas. Although a number of chemical enterprises have access to cheaper gas,[2] an increase in imported natural gas prices will be painful for the energy-intensive Ukrainian economy. Finally, real

[1]Lisichansk Oil Refinery is owned by TNK-BP, one of the largest oil companies in Russia. Fuel supply shortages on the Russian market have prompted the owners of the refinery to boost fuel production using tolling (i.e. the refinery is not required to purchase crude oil but only processes it for a specified fee, then delivering the processed fuel back to the raw materials supplier).

[2]In April 2011, the Cabinet of Ministers of Ukraine allowed select chemical enterprises to import natural gas for their production purposes only, aside from Naftogaz. Before, Naftogaz had a monopoly on natural gas imports to Ukraine. Natural gas for chemical enterprises costs about $170 per 1000 m3 compared to Naftogaz's natural gas imports at $263 per 1000 m3 in 1Q, $296 per 1000 m3 in 2Q, $354 per 1000 m3 in 3Q, and about $390 per 1000 m3 in 4Q 2011.

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sector data for June and July revealed signs of cooling consumer demand, an important driver of economic growth during the first five months of the year. Indeed, retail and restaurant sales turnover eased to 15% yoy over January-July respectively. The deceleration may be attributed to a sharp slowdown in real wage growth (to less than 2% yoy in June compared to about 10% yoy increase over the first four months the year). Although the government announced faster than initially planned increases in public sector wages[3], real wages are unlikely to recover to first quarter levels.

Real Sector Performance of Ukraine
% yoy

	Jan-June 2011	Jan-June 2010	2010	2009	2008
Agricultural output	3.2	3.4	-1	-1.8	17.1
Industrial output	8.7	12.0	11	-21.9	-3.1
Construction works	14.5	-19.3	-5.4	-48.2	-15.8
Domestic trade turnover					
Wholesale trade	-0.8	5.0	0.4	-19.3	-6
Retail trade	15.2	2.3	7.6	-17.4	18.1
Restaurants	12.7	1.1	3.5	-15.6	4.6
Transportation turnover					
Cargo	10.4	14.2	6.4	-22.5	-0.2
Passenger	4.5	-2.3	-0.2	-11.5	4.5
Services, non-financial	18.1	-0.6	2.9	-16.8	15.8

Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

On the upside, economic growth in the second half of 2011 will be supported by good construction sector performance and a generous agricultural harvest. Thus, high budget capital spending underpinned a 14.5% yoy growth in the real value of construction works in January-June 2011. Agriculture is expected to notably improve in the coming months. Heavy rains during the first half of June have caused a later start of the harvesting campaign and adversely affected wheat crop quality. However, the weather was favorable for corn, sugar beets and sunflowers. As a result, the Ministry of Agriculture and Food upgraded its 2011 grain harvest forecast to 47 million tons. At the same time, the first deputy agriculture minister, Mykola Bezugly, announced that the harvest could be as high as 51 million tons in 2011, the second largest crop in the independent history of Ukraine after a record high 2008 harvest of 53.3 million tons. While we believe the lower number is more realistic, it will still be almost 20% higher than in the previous year.

At the same time, gains in these sectors are unlikely to compensate for anticipated weaknesses in export-dependent industry and associated sectors (exports account for 50% of GDP). In addition, rather unexpectedly, wholesale trade turnover fell by 0.8% yoy over the first half of 2011, a notable deceleration compared to 9.7% yoy growth in 1Q 2011. Poor second quarter sector performance may be attributed to weaker industrial production and sluggish export activity during April-May. It may also be partially attributed to the active use of tolling schemes in production of refined petroleum products, and it may reflect consolidation processes in the sector as well as producers' greater emphasis on their own representative companies. The lack of more detailed data does not allow us to assess whether the sector's downturn was of a temporary nature or if it's an indicator of a larger trend of softening economic activity. As domestic trade accounts for about 14% of GDP, the sector may be a significant drag on overall economic growth. Given the above developments and weaker export prospects, the real GDP growth forecast was revised downwards to 4% yoy in 2011.

Fiscal Policy

During the first half of 2011, the Ukrainian government enjoyed a 24.4% yoy nominal increase in budget revenues, with tax revenues growing by 47% yoy. Such an impressive increase was the result of both selected tax rate increases (e.g., higher excise taxes on petroleum products in 1Q 2011 and rent payments) and a general improvement in the economic situation. Thus, due to stronger domestic demand growth and better financial stance of the Ukrainian enterprises, proceeds from the corporate tax (EPT) and value added tax (VAT) rose by a nominal 28% yoy and 50.4% yoy, respectively, over the period.

State Budget Execution in 2011

	Jan-Jun UAH billion	Jan-Jun % yoy	Jan-May % yoy
Total Revenues	139.4	24.4	26.9
Total taxes	119.8	46.9	51.2
EPT	25.5	50.4	56.9
VAT	59.5	27.9	30.5
Excise taxes. total	14.5	14.7	18.7
Duties	4.5	32.6	38.2
Non-tax revenues	17.9	-31.5	-31.2
Total Expenditures*	148.3	6.3	8.9
State Budget Balance	-10.4	2.6 times lower	9.5 times lower
New public debt borrowings	59.5	29.1	47.6
Public debt principal payments	22.2	74.1	2.1 times higher
Privatization receipts	11	-	-

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

The surge in corporate profit tax proceeds was particularly remarkable in the second quarter of 2011 – more than 80% yoy. Such a strong result, however, was only partially explained by the rising profitability of Ukrainian enterprises. Indeed, according to the State Statistics Office of Ukraine, the share of profitable companies (those reporting profits before taxes) grew to 56.8% over January-May 2011, up from about 53% in 1Q 2011 and the first five months of 2010. However, the growth in profit before taxes moderated from 20.4% yoy in 1Q 2011 to 19.7% yoy over April-May. Hence, a surprising upsurge in corporate tax receipts may be attributed to changes in the administration of taxes following the enforcement of the new Tax Code[4]. In contrast

[3]On July 1st, the Cabinet of Ministers raised the first rank in the Unified Labor Tariff Scale system by 1.6% to UAH 635 (about $80), three months ahead of the initial schedule. All public sector wages are set based on the first rank wage and differential coefficients. In addition, the government announced the next increase in the minimum wage (by 2.6% to UAH 985), initially scheduled on October 1st, will be carried out on September 1st, 2011.

[4]Although officially the new Tax Code of Ukraine was enforced on January 1st 2011, part III of the Code, which modifies corporate tax administration rules, was implemented on April 1st. Among other things, the Code changed the definition of income and costs, replaced *the first event rule* with a provision that the earnings/costs of goods/services are accounted for at the moment ownership is transferred from buyer to seller and vice versa. A significant change involves accounting for financial losses in previous periods. According to transitional provisions, financial losses during only 1Q 2011, but not of the other periods, are allowed to be carried forward to 2Q and the two subsequent reporting periods. This provision may be one of the main reasons for the impressive corporate profit tax growth in the second quarter of the year as it created a very favorable base for comparison.

to the corporate profit tax, collections from other major taxes moderated in 2Q 2011, in line with slower economic growth and a reduction in excise taxes. Thus, receipts from excise taxes were only about 4% higher in nominal terms in 2Q 2011 as the government reversed the increase in excises on petroleum products for the second quarter in an attempt to stabilize domestic gasoline prices. At the end of June, the excise tax cuts were also extended for the third quarter of 2011.

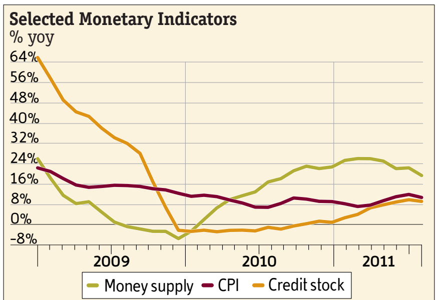
Government expenditures reported rather modest increase of 6.3% yoy over the first half of 2011 as higher spending on infrastructure projects and public debt service were compensated for by slower growth in social security expenditures and lower spending on utility sector and selected education expenditures due to a transfer of their funding to the local level. For instance, improvement in the Pension Fund's finances this year (thanks to growing economy and broader tax base) allowed reducing the state budget subsidy to the Fund by about 45% over January-June 2011. Expenditures on education, accounting for almost 10% of total state budget spending were down by 1.3% yoy in nominal terms for the first half of the year. In addition, expenditures on public administration were 8.3% lower compared to 1H 2010 following a reorganization of state agencies at the end of 2010/beginning of 2011, which envisaged a notable reduction in the size of central and local governments.

Thanks to revenue and expenditure adjustment measures, the first half year state budget ran a UAH 10.4 billion deficit (1.7% of estimated period GDP), 2.6 times lower than in the respective period of last year. Despite likely further deceleration in budget revenues and faster growth in social outlays in the second half of 2011, the year-end state budget deficit target of 2.7% of GDP looks quite realistic. However, as the Ukrainian government repeatedly announced that natural gas tariffs for the population would not be raised, without additional consolidation measures the broad fiscal deficit target of 3.5% of GDP may be missed due to higher Naftogaz imbalances. The Naftogaz deficit is targeted at UAH 8.5 billion, or 0.7% of GDP, in 2011. However, due to delayed adjustment of natural gas tariffs and higher than anticipated prices for imported natural gas[5], the Naftogaz deficit may reach UAH 15 billion, or about 1.2% of GDP. Sustaining the financial stance of Naftogaz remains one of the most critical requirements of the IMF to resume financing to Ukraine. Currently, the government has accumulated significant resources to cover its fiscal deficit and there is no fiscal need for IMF funds. However, further cooperation with the IMF is important for Ukraine as it affects foreign investors' confidence in the Ukrainian economy, and hence their willingness to rollover Ukraine's foreign debt, and relations with other international financial institutions. Given recently intensified risks of adverse external developments, the resumption of the IMF program appears to be essential to increase the country's resilience to external shocks.

Monetary Policy

Ukraine's consumer inflation declined sharply by 1.3% in July 2011 compared to the previous month, mainly on account of a seasonal reduction in food prices. Thus, prices for food and beverages, the weightiest component in the consumer basket, fell by 2.9% month-over-month (mom). Food deflation was led by a 3.7% mom reduction in fruit prices and a 32.6% mom drop in the cost of vegetables. Within the latter group, droughty weather during May and June raised concerns that there could be a potato shortage in 2011. This caused potato prices to surge up by 43% during these two months. As weather conditions notably improved at the end of June and deficit fears faded, potato prices plummeted by almost 37% mom in July. In annual terms, consumer inflation eased to 10.6% yoy in July, down from almost 12% yoy a month before.

Selected Monetary Indicators



Source: State Statistics Committee, NBU, The Bleyzer Foundation

Due to a better than projected agricultural harvest, easing pressures from world commodity prices and likely slower economic growth signal slower inflation growth than was previously expected. However, as higher excise taxes will be reinstated in the fall of this year, there are gasoline supply shortages and there will be a powerful base effect in the last quarter of 2011, consumer inflation is unlikely to be reduced to single digits. We see consumer prices growing by about 10-11% yoy at year-end.

Development of monetary aggregates was mixed in July. Tighter monetary policy since the end of June, sizable sterilization operations and higher reserve requirements have reduced banking sector liquidity. Thus, cash balances on commercial banks correspondent accounts fell to 2.5% in July compared to the previous month and hit the three-year low of UAH 12.6 billion. Average interest rates on the inter-bank credit market rose to 5.1% pa in July, up from 4.3% pa in June. On the other hand, the monetary base grew by 3.4% mom in July, which may be attributed to monetization of government securities issued to recapitalize Naftogaz. In addition, due to tighter regulation of banks' open foreign currency positions (the difference between foreign currency assets and liabilities), as anticipated, resulted in higher foreign currency supply on the forex market. This allowed the NBU to reduce its foreign currency sale interventions to support the Hryvnia exchange rate from $1.5 billion in June to $0.3 billion in July. However, as a result, NBU interventions had

[5]The 2011 Naftogaz budget was developed based on an average price of imported natural gas of $269 per 1000 m3 in 2011. However, the actual price may exceed $300 per 1000 m3.

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a limited ‘sterilizing effect’ on monetary base. In contrast to monetary base, money supply grew by a moderate 0.7% mom in July, mainly on account of legal entities’ deposit outflow.

Lower banking sector liquidity may constrain credit activity, which still remains relatively weak. Thus, the stock of commercial bank loans grew by 0.6% mom in July compared to a 2.5% mom increase a month before. In annual terms, credit growth eased to 9% yoy in July, from almost 10% yoy in June. Deeper credit data readings reveal that the rise in commercial banks’ stock of credit as of end of June was achieved mainly on account of a 180% yoy increase in loans to state-owned enterprises. Meanwhile, the stock of loans to non-state companies showed a rather anemic growth of 10.7% yoy in June 2011. The growth was even lower than in June 2010, when the stock of loans to non-state enterprises advanced by 11% yoy. At the same time, consumer credit in national currency has been gaining strength, advancing by almost 17% yoy in June. Although revival of consumer credit supports domestic consumption, it also stimulates imports.

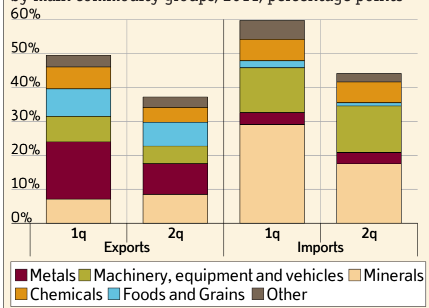
International Trade and Capital

The elimination of grain export quotas and lower volumes of natural gas imports helped reduce Ukraine’s foreign trade deficit in goods to $0.5 billion in June, almost twice as low as in the previous month. Indeed, export of goods picked up by 42% yoy in June compared to 36% yoy in May, underpinned by a 70.5% yoy increase in the export of foods and agricultural products. At the same time, the export of metallurgical products, machinery and equipment reported little gain, facing less benign external conditions. On the import side, robust domestic demand kept fuelling imports, although thanks to a higher statistical base effect the growth in imports moderated from almost 53% yoy in May to 43% yoy the next month. In particular, the fastest deceleration was observed in import of chemical products (24% yoy in June compared to 41% yoy in May) and machinery and transport vehicles (65% yoy vs. 90.6% yoy respectively). At the same time, despite lower volumes of natural gas imports, import of mineral products even accelerated to 62% yoy in June (up from 60% yoy in May) amid higher crude oil and refined petroleum imports.

A lower trade deficit was among the main causes of the current account deficit narrowing to $0.2 billion in June. The cumulative current account gap, however, reached $2.5 billion over January-June compared to a $0.5 billion surplus in the first half of 2010. Despite June’s improvement in the current account, anticipated weaker export growth due to lower commodity growth and slower economic growth in Ukraine’s main trading partner countries and strong import growth, the current account deficit is forecast to increase in the second half of 2011. The full-year deficit may thus reach 4.5% of GDP in 2011.

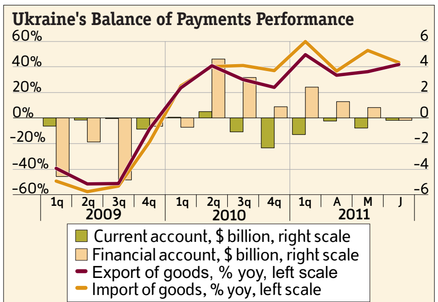
Ukraine has secured a significant surplus in the financial account over the first half of 2011. At the same time, the surplus was achieved mainly due to rising foreign sovereign and quasi-sovereign debt. Net FDI inflow, excluding Ukrtelecom privatization proceeds, was rather disappointing, while new banking and corporate sectors’ borrowings (excluding quasi-sovereign) were lower than repayments. Intensified risk aversion due to fears of EU debt crisis spreading to Spain and Italy and global economic growth slowdown may adversely affect foreign capital inflows to Ukraine in the second half of the year. Although massive capital outflows are quite unlikely, Ukraine’s banking and private sector may face difficulties in maintaining external debt roll-over ratios even at levels similar to the first half of the year. Already in June, despite the fact that Ukraine issued $1.25 billion Eurobonds in the middle of the month, the financial account balance saw a small deficit amid higher private sector debt repayments and large purchases of foreign currency by the population.

Contributions to Merchandise Export and Import Growth
by main commodity groups, 2011, percentage points



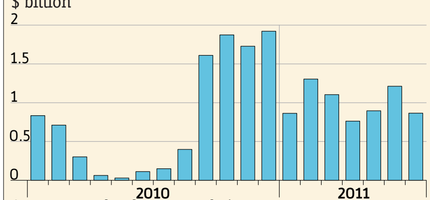
Source: State Statistics Committee, NBU, The Bleyzer Foundation

Ukraine's Balance of Payments Performance



Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Net Purchases of Foreign Currency by Population
$ billion



Source: NBU, The Bleyzer Foundation

Population demand for foreign currency remains surprisingly high in 2011. For the first seven months of 2011, net population purchases of foreign currency amounted to $7 billion, much higher than in the respective period of last year. Coupled with a widening current account deficit and higher external debt repayments, these will pressure the Hryvnia to depreciate. At the same time, the current level of gross international reserves at $38.7 billion as of end-July allows the NBU to keep the Hryvnia exchange rate stable for a while. On the other hand, as Ukraine keeps losing competitiveness due to higher inflation compared to price growth in its main trading partners and export prospects have weakened, some Hryvnia depreciation should materialize over the medium term.

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