Summary

- Macroeconomic conditions remain difficult in Ukraine, as most sectors reported substantial declines in economic activities in the first two months of 2009.
- Though the government collected budget revenues above the planned amounts, deeper fiscal data readings suggest that state finances are under significant strain this year.
- Annual consumer price inflation decelerated to 18.1% in March 2009. Despite a number of upwards pressures on prices, inflation is likely to decline to about 15% yoy at the end of the year.
- The foreign exchange market was quite volatile in February, but the situation stabilized during March.
- Banking sector weaknesses are currently seen as the main vulnerability of the Ukrainian economy.
- Ukraine’s external position deteriorated in February; however, foreign trade and the current account are forecasted to improve significantly this year.
- In April, the IMF and Ukrainian government authorities resumed negotiations on a revised stand-by agreement.
- With the IMF and other international institutions' financing, the level of private debt repayments will be feasible, reducing the pressures on the balance of payments and thus the Hryvnia exchange rate.

Economic Growth

February 2009 indicators show that Ukrainian macro conditions remain difficult. Although the State Statistics Committee of Ukraine reported an increase in industrial production by 5.4% month-over-month (mom) in February, the rebound was attributed to a sizable decline in January, caused by gas supply cut-offs and holiday shutdowns among other factors. In annual terms, industrial output was down 31.6% from February 2008. Other sectors, except for agriculture, also demonstrated weak economic data.
The decline in economic activity was broad-based. Moreover, it was much deeper than in other countries affected by the global financial crisis due to the relatively undiversified structure of the economy. Ukraine’s exports of goods and services account for almost 50% of GDP with metallurgy, chemicals and machine-building making up almost 70% of total exports in goods. Ukraine grew at a very high pace of about 8% per year on average over the last five years thanks to strong growth of foreign demand, rallying commodity prices as well as plentiful capital inflows that spurred commercial bank lending to grow by about 60% per annum over the period. As the global financial crisis worsened, these growth engines started to vanish rapidly. The contraction was particularly sharp in export-oriented and credit-dependent industries and sectors.

Thus, machine-building production, of which more than 60% was destined for foreign markets (particularly for Russia), plummeted by 55.6% yoy in January-February 2009. Production of transport vehicles was hit the hardest. Suffering from rapidly falling external demand and collapsed auto crediting, the industry showed a record drop of 64% yoy. Production of metallurgical and chemical products was 43% below the level of January-February 2008. Due to the sharp decrease in iron ore prices and the downturn in metallurgy, the extractive industry declined by 19% yoy. On the back of weak economic activity and limited export opportunities, production of electricity sank by 15% yoy.

Poor industrial sector performance and plunging external trade caused an almost 30% slide in wholesale trade and a 40% yoy decline in cargo transportation. The limited ability of the banking sector to provide credit and the downward revision of investment plans by the corporate sector aggravated the downturn in the construction sector. The value of construction works was almost 60% yoy lower than in the first ten months of 2008 in comparative prices. Closely linked to the construction sector, production of non-metal mineral products (mostly construction materials) dropped by 52% yoy.

4Q 2008 and January 2009 data suggests that a sudden and sharp decline in external demand and commodity prices and the drying up of foreign capital since August 2008 were the most powerful means through which the world financial crisis affected Ukraine. At the same time, February’s statistics revealed that the impact on domestic demand has been increasing. With real wages declining by 14% yoy during the first two months of the year, growing wage arrears and unemployment, and tighter credit, the performance of domestic-oriented sectors has been rapidly deteriorating. Retail trade turnover, passenger transportation and food processing sank by almost 11% yoy, 9% yoy and 12% yoy respectively. The degree of real sector deterioration in the first two months of the year led us to downgrade the forecast for real GDP growth to -7% yoy in 2009.

**Fiscal Policy**

Revenues to the general fund of the state budget were declared in the amount of UAH 12.5 billion ($1.6 billion) and UAH 12.9 billion ($1.7 billion), about 2.4% and 2.2% above the targeted amount for February and March 2009 respectively. The over-fulfillment contrasts sharply with poor real sector and foreign trade performance. Moreover, it looks even more puzzling if taking into account that 2009 budget revenues (and hence the monthly revenue plans) were developed on a very optimistic macroeconomic forecast (real GDP was forecasted to increase by 0.4% yoy in 2009). This may signal about the underscoring of planned budget revenues for the first quarter of 2009. In addition, deeper fiscal data shows that budget finances are under significant strain this year.

<table>
<thead>
<tr>
<th>State Budget Execution in 2009</th>
<th>Real change*</th>
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<tbody>
<tr>
<td>% yoy</td>
<td>Jan-09</td>
</tr>
<tr>
<td>Total revenues</td>
<td>-20.1</td>
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<tr>
<td>Tax revenues</td>
<td>-16.6</td>
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<tr>
<td>EPT</td>
<td>-20.1</td>
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<tr>
<td>VAT</td>
<td>-15.1</td>
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<tr>
<td>Excises**</td>
<td>8.2</td>
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<tr>
<td>Import duties</td>
<td>-58.9</td>
</tr>
<tr>
<td>Non-tax revenues</td>
<td>-27.9</td>
</tr>
<tr>
<td>Total Expenditures</td>
<td>-25.3</td>
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</tbody>
</table>

* CPI deflated
** The increase in excise receipts is attributed to higher rates enacted at the end of December 2008. At the same time, the decline in real terms is explained by a sharp drop in the production of excisable goods - tobacco, cars, gasoline.

Source: Ministry of Economy, Ministry of Finance, The Bleyzer Foundation
The over-execution of budget revenues was achieved mainly thanks to the government reliance on one-off transactions unforeseen in the budget, early payment of tax bills and other charges to the budget. Customs cleared 11 billion m³ of natural gas imported into Ukraine last year, the ownership of which is currently being disputed in the courts with RosUkrEnergo, the former monopolistic mediator of natural gas supplies to Ukraine. According to estimates, about UAH 3 billion ($0.4 billion), or about 7% of total state budget revenues for January-March 2009, were extra VAT proceeds from this transaction.

Furthermore, at the beginning of February 2009, the parliament endorsed the government’s bill introducing a 13% temporary import duty markup on a wide range of goods. The law came into force at the beginning of March. Though later that month the government abolished the markup⁠¹, it remained active during most of March. In addition, there is evidence that the revenue collection agencies strengthened their efforts in encouraging voluntary early payment of tax bills and other charges to the budget.⁠² Yet in January 2009, the government induced the National bank of Ukraine (NBU) to transfer about UAH 1 billion to make up the difference between its revenues and expenditures, though these payments were due at the end of March. In February 2009, an almost twofold annual increase in non-tax revenues to the state budget was reported. In particular, UAH 3.1 billion were allocated to the budget from “other own revenue sources of public sector institutions,”⁠³ which account for about 97% of the annual target. As a result, non-tax revenues grew by a strong 37% yoy in nominal terms over the first two months of the year. Though these receipts helped to fill the state coffers, they cannot be a sustainable basis to fund recurrent expenditures, which accounted for almost 90% of total state budget expenditures in 2008.

Contrary to non-tax receipts, the tax revenues stream mirrored the developments in real and foreign trade sectors, declining by about 23% yoy in CPI deflated terms over January-February 2009 and by almost 30% yoy in February alone. At the same time, execution of state budget expenditures notably improved in February compared to the previous month. In January 2009, a 10% yoy nominal decline in state budget expenditures reflected typical under-execution of budget expenditures related to general uncertainty about budget revenues at the beginning of the year. In February, spending from the budget grew by a nominal 22% yoy compared to a 7% yoy rise in revenues. State budget spending for March 2009 and detailed information on expenditures in February were not available. Moreover, there is scarce information on the execution of local budgets during these two months. All of this points to a rather tight fiscal situation, which is indirectly supported by the developments of cash balances on the unified state treasury account. By mid-March 2009, the cash balances stood at UAH 1.4 billion, the lowest level since 2002.

February’s state budget deficit of UAH 1.5 billion was covered mainly thanks to the indirect NBU financing⁠⁴ and cash balances accumulated on the Treasury accounts in the previous periods. At the same time, in mid-March 2009, the parliament amended the 2009 budget law, eliminating those provisions that threatened the independence of the NBU: the obligation of the NBU to purchase domestic government bonds to finance the fiscal deficit and the requirement to seek cabinet agreement on the NBU’s bank refinancing policy. Government domestic securities remain unattractive

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¹ Except for cars and refrigerators.
² According to unofficial information, the tax collection agencies urge corporate enterprises to pay corporate profit tax on a monthly basis, although this tax is charged on a quarterly basis.
³ The government did not disclose greater details about these revenue sources. According to the Cabinet of Ministers Decree #659 as of May 17, 2002, “other own revenue sources of the public sector institutions” are comprised of charitable donations, grants and gifts as well as funds transferred to the public institution for accomplishment of specified services (i.e., residential construction). These sources are defined as one-off receipts.
⁴ The 2009 budget law article 84, the NBU was obliged to purchase domestic government bonds from the commercial banks in three days after the bank’s request, which de-facto meant monetization of the fiscal deficit.
for commercial banks due to low premium and current liquidity constraints in the banking system. Hence, the government has to either revise downwards budget expenditures or find non-inflationary sources to finance the fiscal deficit, planned at a record high UAH 31 billion ($3.9 billion, or 3% of forecasted GDP). This also coincides with the IMF requirements to resume the Fund’s stand-by program with Ukraine, terminated in mid-February. Given the upcoming presidential election, some combination of the two approaches appears to be the most likely scenario.

Monetary Policy

Following acceleration in January 2009, retail price growth slowed to 1.5% month-over-month (mom) and 1.4% mom in February and March respectively. On the upside, a sharp Hryvnia depreciation continued to spill-over into the domestic retail market. In particular, medicine, clothes and footwear, and household equipment and furniture, the lion’s share of which are imports, were 47.1%, 7.7% and 24.6% more expensive than in March 2008. A weaker Hryvnia as well as resumed growth of world crude oil prices (though quite moderate) caused domestic gasoline prices to increase by about 19% from January through March 2009. The upward pressure on consumer prices also came from a rise in excises, transportation costs and household utilities.

At the same time, declining real household incomes and a major reduction in money supply and credit exerted downward pressure on consumer prices this year. Coupled with a favorable statistical base effect, annual inflation slowed to 18.1% yoy in March. In addition, the adjustment of a number of utility tariffs (for natural gas, electricity, etc.) to cost-covering levels was deferred. Moreover, the likelihood of a major increase in these tariff rates decreases closer to the presidential election. However, the above-mentioned upward pressures (which are likely to remain strong through the rest of the year) and the vanishing favorable statistical base effect in the second half of the year will keep inflation at around 15% in 2009.

The foreign exchange market was quite volatile during February but showed signs of stabilization in March. The foreign trade and current account balances notably improved during the first two months of the year. However, exports fell sharply, reducing the inflow
of foreign exchange to the country. In addition, large short-term external debt payments due in 2009 amid virtually closed international financial markets and termination of the IMF program and low population confidence in the crisis resolution measures of government kept feeding the depreciation pressures.

At the same time, the NBU continued to actively support the market not only by selling its foreign exchange reserves but also introducing special foreign currency auctions for the population and using administrative controls. Special forex auctions allowed households to buy foreign currency at a preferential rate to service their foreign-currency denominated debts. This innovation helped to reduce demand for foreign currency at the retail foreign exchange market. In March 2009, population net purchases of foreign exchange amounted to $0.6 billion compared to almost $1.5 billion a month before. Lower demand as well as improved transparency of the NBU intervention and refinancing policy led to relative stabilization of the inter-bank forex market. This, in turn, contributed to some slowdown of deposit outflow and reduced the size of the NBU interventions.

However, sharp Hryvnia devaluation during the last quarter of 2008, the severe economic downturn, high foreign debt burden and ongoing deposit outflow have continued to stress the banking system. In March, about 2% of deposits flew out of the banking system. At the same time, the speed of deposit outflow decelerated in March compared to a 5.6% mom decline in February. Though official data is not available, there is evidence of rapidly rising non-performing loans. In addition, the high foreign indebtedness of the Ukrainian banking system also exacts a toll on banking system stability. During February-March the NBU took over another eight banks (in addition to the previous four) and began monitoring several other banks. The central bank has actively supported banking system liquidity through its refinancing operations. During these two months, the NBU provided almost UAH 30 billion. In addition, the government reduced cash balances on its accounts with the NBU by UAH 5.5 billion in March, which also contributed to a moderate rise in banking system liquidity.

Simultaneously, the NBU continued to tightly monitor the liquidity stance of the banking system, though inflation is not currently the main issue. In March, the central bank absorbed about UAH 7.2 billion, compared to about UAH 3.4 billion in the previous two months combined. At the same time, the cumulative impact of the NBU sterilization operations and its sale of foreign reserves did not outweigh the effect from the refinancing operations and reduction in cash balances on government accounts with the NBU. As a result, following a two-month decline, the monetary base grew by 0.8% mom in March. Due to continuing deposit flight from the banking system, money supply (M3) kept declining, falling by 10% since the beginning of the year.

All of the above affected the commercial banks’ ability and willingness to provide credit to the economy of Ukraine. Over the first three months of the year, the stock of bank credit declined by 2.4% year-to-date (ytd), mainly on account of forex-denominated loans, which fell by 6.3% ytd. On the contrary, the stock of Hryvnia-denominated loans grew by 3.3% ytd, which may be attributed to the growing practices of converting existing loans from foreign currency into domestic. The government and monetary authorities are currently developing the recapitalization program of the Ukrainian banking system with public funds. If the recapitalization plans are successful, systemic issues may be under control, though a number of medium and small banks may fail. At the same time, credit activity is expected to remain low during the next couple of years, impeding the recovery.

**International Trade and Capital**

As expected, February 2009 showed some deterioration of Ukraine’s external position. Due to weak external demand...
and low world commodity prices, Ukrainian exports of goods fell by almost 43% yoy that month. As a result, two-month exports were 38.6% lower than in January-February 2008. The deterioration may be attributed to weakening of economic growth in emerging economies, particularly Russia and Turkey. Accounting for 23.5% and 7% of total merchandise exports, sale of goods to these two countries declined by 52.7% yoy and 67.6% yoy respectively over the first two months of 2009. At the same time, on account of resumed natural gas imports, the monthly value of imports almost doubled in February compared to the previous month. Though imports of other commodities (particularly machinery and transport equipment, chemicals and metallurgical products) fell sharper than the month before, total imports showed a decline of 41.4% yoy in February, compared to a 56% yoy drop in January 2009. As a result, the FOB/CIF trade balance turned into a deficit of $1.1 billion in February. On a positive note, the two-month foreign trade deficit in goods was almost 75% lower than in the respective period last year.

Given the magnitude of non-energy imports decline, lower annual volumes of natural gas imports as well as the government’s temporary measures to curb imports, we expect imports to plunge by more than 30% yoy in 2009 in dollar value terms. Though exports are forecasted to decline, foreign trade and current account deficits may improve substantially in 2009. The current account could be reduced to $1.3 billion, or 1% of forecasted GDP. Thus, one of the main vulnerabilities of the Ukrainian economy that led to the financial crisis will be under control.

On the other hand, the main pressures on the balance of payments and, hence, domestic currency will come from the substantial external-debt payments due in 2009, which may be as high as $35 billion. At the same time, considering that a substantial portion of this debt constitutes trade credits and credits of foreign banks to their Ukrainian subsidiaries, with the IMF disbursement and likely financing available from other international institutions, the level of private debt repayments may be feasible. Indeed, February’s preliminary balance of payments statistics was encouraging - the inflow of long-term private debt outpaced the debt repayments due that month.

Other Developments Affecting the Investment Climate

At the beginning of April, the IMF mission visited Ukraine at the request of the Ukrainian government to resume negotiations on the IMF stand-by program. The program was delayed in mid-February as Ukraine failed to approve a balanced budget for 2009. At the same time, observing the magnitude of the economic downturn in Ukraine, the IMF mission indicated it may agree to a budget deficit if it is financed by non-monetary sources. In addition, balancing the Pension Fund of Ukraine and the national natural gas monopoly “Naftogaz Ukrainy” was among the main requirements. Though there was a broad understanding among various political forces of the need to revive the IMF program, the parliament failed to vote for the necessary amendments to the budget law and pension legislation in mid-April. Meanwhile, the government introduced the necessary measures through Cabinet of Ministers decrees.

Although the method of fulfilling the IMF requirements was imperfect, the mission praised the Ukrainian authorities’ efforts to restore cooperation with the Fund. Hence, there is a good chance the program will be resumed in May. At the same time, according to the original IMF stand-by agreement, the third tranche of the IMF credit funds was planned to be disbursed in May. Thus, the Ukrainian authorities have been negotiating for the disbursement of the second and the third tranches together. Although we believe there is a low probability for this to happen, the IMF may consider increasing the size of the second tranche to Ukraine. The resumption of the IMF program will unblock all other external sources of financial assistance to Ukraine (World Bank, EBRD, etc.). With the support of international financial organizations, the existing vulnerabilities of the Ukrainian economy could be addressed, increasing the probability the crisis is contained during 2009. GDP recovery could take place in 2010, following the recovery of the world economy.