July 2010

Executive Summary

A favorable external environment kept supporting Ukraine's economic recovery. Industrial production grew by 12.6% yoy over January-May 2010, led by export-focused machine-building, chemicals and metallurgy. At the same time, in May 2010 economic activity cooled somewhat in response to easing world commodity prices. However, despite continued price corrections, their current levels remain comfortable for economic recovery in Ukraine to continue. In addition, May's real sector data indicated noticeable improvement in domestic demand.

Budget revenue results showed a weak correlation with improved economic activity in the country. On the contrary, budget expenditures grew at a robust pace. In May 2010, budget spending surged by 70% yoy, leading to substantial widening in the state budget deficit. As a result, the five-month state budget deficit stood at UAH 15.2 billion ($1.9 billion), up from UAH 3.8 billion for the first four months of 2010. With budget revenues falling notably behind the annual plan and spending still high, there are growing concerns over the government's ability to meet its 5.3% of GDP deficit target for 2010. The feasibility of the fiscal deficit target was the main cause of IMF concern. At the beginning of July, a staff-level agreement with the IMF was achieved on a new loan program of up to $14.9 billion. At the beginning of July, a staff-level agreement with the IMF was achieved on a new loan program of up to $14.9 billion. In June, government authorities initiated tax reform in the country.

During April-May 2010, Ukraine made significant progress in reducing inflation. Annual consumer price index growth fell to 8.5% in May 2010 on the back of still weak domestic demand, a delay in utility tariff increases, correction of world commodity prices and favorable developments on the foreign exchange market. Acceleration of monetary aggregates growth (due to the NBU's buy-out of foreign currency surplus on the foreign exchange market and indirect monetization of the budget deficit), a likely utility tariff adjustment and forecasted revival of commercial bank credit in the second half of the year support our forecast of consumer price growth at about 13% in 2010. On June 8th, the NBU reduced its discount rate to 9.5% in an attempt to stimulate credit activity. Though the link between the discount rate and credit activity is currently weak, the benefits of a lower discount rate will be passed on to potential borrowers.

So far, sluggish credit activity helped to contain the growth of imports. Coupled with stronger exports, this brought Ukraine's current account into surplus of $0.3 billion for the five months of the year. The capital account has also notably improved. As a result of a positive balance of payments, the NBU replenished its international reserves to $29.5 billion at the end of June.
Economic Growth

April's data showed broad upside in most economic sectors, strengthening expectations that the economy may show acceleration in 2Q 2010. Ukrainian industrial production grew by 12.6% yoy between January and April, up from 10.8% yoy reported for the first quarter of 2010. As in the previous periods, export-focused machine-building, chemicals and metallurgy continued to lead.

A decent economic rebound in Russia, which accounts for more than half of Ukraine's exports of machinery, underpinned a 28% yoy growth in machine-building production over the first four months of the year. Improved global demand has pushed fertilizer prices up, favoring Ukraine's export-oriented chemical industry. The industry reported an almost 24% yoy growth in output over the first four months of 2010. Benefiting from climbing international steel prices, the Ukrainian production of basic iron and steel products grew by 22.2% yoy from January to April. The upturn in exports and industrial production supported an expansion in cargo transportation and wholesale trade. These sectors' turnover grew by 14.2% yoy and 4.3% yoy over the period, respectively.

In May 2010, the global environment has to deteriorate, which was reflected in easing commodity prices. Being sensitive to international price movements, Ukraine's real sector responded by slight deceleration in economic activity. Thus, the growth in industrial production eased from 17.4% yoy in April to 12.7% yoy in May, though five-month cumulative growth remained unchanged at 12.6% yoy. The deceleration was led by metallurgy and oil-refining. Metallurgical production slowed from 33.4% yoy in April to 21.2% yoy in May. Downward correction of world energy prices and deceleration in metallurgy resulted in an 11.7% yoy reduction in production of coke and oil-refining in May 2010 compared to a 17.7% yoy growth a month before.

On a positive note, although world commodity prices (particularly on steel products) have been trending downwards since mid-May, their current levels remain supportive for economic recovery in Ukraine to continue. Furthermore, May's real sector data indicated notable improvement in domestic demand. In particular, retail trade turnover, typically used to gauge domestic consumption patterns, was up by 1.1% yoy over January-May 2010 (was still down by 2.1% yoy in January-April). Decent real wage growth (6% yoy for January-April), a stable foreign exchange market and improving macroeconomic and political situations may have positively affected population confidence and thus spending, though bank credit activity, one of the main drivers of domestic consumption in 2007-2008, remained subdued.

With expected revival of bank credit activity in the second half of the year and favorable external market conditions, Ukraine's economy is forecasted to grow by 4.5% yoy in 2010. At the same time, the worsening of the Eurozone's sovereign debt crisis and its greater effect on the world economy represent downside risks to the forecast.

Fiscal Policy

Budget revenue results showed weak correlation with improved economic activity in the country. State budget proceeds grew by only 5.5% yoy in nominal terms over the first four months of the year. The growth was mainly attributed to higher excise receipts (excise tax rates were raised several times throughout 2009), larger amounts collected from corporate entities (in April, corporate entities file their first-quarter profit tax returns) and advance transfer of NBU profits to the budget (the NBU conveyed UAH 4.7 billion ($0.6 billion) over January-April while according to preliminary budget execution plan the Bank had to supply only UAH 1.1 billion in the second quarter of 2010). At the same time, proceeds from value added tax were disappointing as they fell short by about 24% of the January-April target. State coffers would have received even smaller VAT receipts if VAT was fully refunded. For the first four months of
2010, VAT refunds decreased by almost half compared to the respective period last year. Total claims for VAT refunds reached UAH 36 billion ($4.5 billion) as of June 2010, though the State Tax Administration acknowledged only UAH 26 billion. The government plans to convert about 70% of the latter amount (principally VAT refund arrears accumulated in the previous year) into 5-year T-bills with a 5.5% yield and a 10% principal payment every six months. But the likely date and other terms of the issuance were not announced.

The situation with state budget revenue collections did not improve in May. According to preliminary data, state budget revenues in May were almost 14% lower than the month before. As a result, five-month budget proceeds stood at UAH 93.8 billion, representing only 35% of the annual target. For the entire year, the government projects to collect UAH 266.1 billion, or 27% yoy higher, while state budget revenues were up by less than 6% yoy for January-May. With budget revenues falling notably behind the annual plan and spending being kept high, there are growing concerns over the government’s ability to meet its 5.3% of GDP deficit target for 2010.

Government spending totaled UAH 109.9 billion ($13.9 billion) over January-May 2010, almost 20% higher than the respective period last year. In May alone, state budget expenditures grew by a nominal 45% compared to April 2010 and were 70% higher than in May 2009. Although the composition of budget spending for January-May 2010 is not available yet, May’s surge in expenditures may be attributed to the ‘catch-up’ in funding of various programs, withheld during the first four months of the year in the absence of a 2010 state budget law. Thus, social liabilities of the government have risen in accordance with the 2010 budget plan of minimum pension and minimum wage increases. In addition, in mid-May 2010, the government raised the size of the first rank of the Unified Tariff Scale System, used as the basis for setting employees’ salaries in the public sector. Although the decision was made in mid-May 2010, the increase was applied retroactively; salaries were raised by 1.8% as of January 1st, 2010 and by 2.2% as of April 1st, 2010. All in all, the nominal monthly average wage was up by 19% yoy in May 2010.

Higher budget expenditures amid modest growth in revenues resulted in notable widening of the state budget deficit in May 2010. Over the first four months of the year, the state budget deficit stood at UAH 3.8 billion ($0.5 billion). According to preliminary data, the deficit reached UAH 15.2 billion ($1.9 billion) over January-May. This number, however, does not include the implicit Pension Fund deficit as well as Naftogaz imbalances. Indeed, the Pension Fund of Ukraine kept ‘borrowing’ from the state budget to fully meet its social liabilities. For the first four months of 2010, the Pension Fund’s net debt outstanding to the state budget grew by UAH 6.4 billion ($0.8 billion) and reached UAH 28.5 billion ($3.6 billion) as of April 2010. Sizable Pension Fund imbalances and rapid population aging signal for urgent measures to reform the pension system of Ukraine. Raising the retirement age, which is one of the lowest in the world, seems an obvious solution to balance pension books. Government authorities have already announced the pos-
sibility of gradually equalizing the retirement age for men and women. However, the heated public reaction to the plan and short election cycles make it difficult to implement.

Despite the gas price discount deal, Naftogaz finances remain strained. The government authorities declared Naftogaz imbalances will be contained to 1% of GDP, which would be consistent with the IMF requirements. However, the target will be achieved only if the government raises natural gas tariffs for the population and utility sector, a move delayed so far. In addition, at the beginning of June 2010, a Stockholm court obliged Naftogaz to return 12.1 bcm of natural gas to gas-trader RosUkrEnergo (RUE). If the court decision is enforced, the Naftogaz deficit may grow to 4% of GDP. At the same time, debates over the legality of the court decision and of the process of international court decision enforcement in Ukraine suggest some kind of compromise between Naftogaz and RUE will be reached, which would not affect Naftogaz’s finances this year.

Concerns over the ability of the Ukrainian authorities to limit the consolidated general government deficit (including Pension Fund deficit) and Naftogaz imbalances to 5.5% of GDP and 1% of GDP respectively were among the main reasons of protracted negotiations with the IMF. The Ukrainian government wanted a new loan from the IMF of up to $19 billion for 2.5 years with part of the funds directed at financing the budget deficit. Following tough negotiations, a staff-level agreement was reached in early July, which would require IMF Management and Executive Board approval, which would be conditional on the Ukrainian parliament’s adoption of legislative changes related to the budget, financial and energy sectors. Though the new program it not yet functioning, the staff-level agreement is a strong positive signal that Ukraine’s public finances will be under control. Resumed cooperation with the IMF will allow Ukraine to receive financing from other international organizations, including a European Commission loan estimated at EUR 610 million. It may also help to reduce the cost of borrowing on international financial markets. The latter is particularly important as the government plans to attract about $1.3-1.5 billion by issuing Eurobonds. Initially, the placement was scheduled for May-June 2010. Several successful corporates and banks’ placements during April-May indicated the timing for sovereign debt issuance on foreign markets was favorable. However, the Eurozone's sovereign debt crisis caused investor confidence to deteriorate rapidly, leading to risk re-pricing and risk-aversion. Amid also lingering IMF negotiations, the placement of Ukraine's sovereigns was delayed.

In the absence of external financing, domestic borrowing remained the principal source of budget deficit financing. As in the previous periods, a substantial portion of domestic debt securities was monetized by the National Bank of Ukraine. Observing acceleration of money supply growth in recent months, the government authorities have been actively seeking alternative funding. Thus, in June 2010, large-scale privatization was resumed via re-sale of a 76% stake in Luhansktepl佐voz, one of the leading machine building producers in Ukraine specializing in diesel and electric locomotives. The plant was sold to Briansk Machinery Plant for UAH 410 million ($51.8 million). However, as the auction was not fully transparent, privatization is unlikely to generate sufficient receipts to the budget. Hence, to cover the significant fiscal deficit, the government negotiated a $2 billion loan from the state-run Russian bank.

Realizing, however, that both methods of deficit financing (accumulation of debt and privatization) are not sustainable in the long run, the government has also taken measures to narrow the budget deficit. In particular, in mid-May 2010 the parliament amended Ukrainian taxation legislation, raising excise duties, rent payments and tariffs and tightening tax administration. However, an increase in taxes and excise duties, rent payments and tariffs and tightening tax administration. However, an increase in taxes and excise duties, rent payments and tariffs and tightening tax administration. However, an increase in taxes and excise duties, rent payments and tariffs and tightening tax administration. However, an increase in taxes and

changes into Main Taxes Proposed by the New Draft Tax Code

<table>
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<tr>
<th>Tax Current Proposed</th>
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<tr>
<td>Corporate Profit Tax rate</td>
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<td>Value Added Tax rate</td>
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<tr>
<td>Personal Income Tax rate</td>
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<tr>
<td>Deposit and investments revenues</td>
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<tr>
<td>Simplified taxation system</td>
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<tr>
<td>UAH 20-200, sales proceeds should not exceed UAH 500,000 ($63,100) for private entrepreneurs; 6% if legal entity is VAT tax payer; 10% if legal entity is not a VAT tax payer;</td>
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<tr>
<td>Sales proceeds of a legal entrepreneur should not exceed UAH 1 million ($126,260) in both cases.</td>
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<tr>
<td>From January 1st, 2011 to December 2015 - 0% unified tax for private entrepreneurs - physical entities if their sales proceeds do not exceed UAH 300,000 ($37,900); 6% unified tax for private entrepreneurs - legal entities if their sales proceeds do not exceed 10,000 minimum wages (i.e., UAH 2.7 billion, $0.14 billion).</td>
</tr>
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<td>Significant narrowing of types of activities eligible for simplified taxation.</td>
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1The Law #6337 “On Amendments to Certain Legislative Acts of Ukraine (regarding taxation)” was approved on May 20th, 2010.

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tension of State Tax Administration authorities amid an already high tax burden and generally unclear and arduous tax procedures may not produce the desired outcome. A large shadow economy and massive tax evasion prompted the government to initiate tax reform in the country. At the beginning of June, the government presented the Draft of the new Tax Code of Ukraine, proposing to cut major tax rates and simplify book-keeping. Simultaneously, it proposed to further extend the authorities of State Tax Administration and introduce some other taxes (i.e., bank deposit tax). The Draft Tax Code was already approved in the first reading by the parliament. But it is likely to be significantly amended during the next readings as the draft was criticized for dubious interpretation of norms, the potential to increase administrative pressure on business and corruption, etc. Though the Code was poorly drafted, the very fact that long-awaited tax reform has begun is welcomed.

Monetary Policy
During April-May 2010, Ukraine made significant progress in reducing inflation. During these two months, the consumer price index fell by almost 1% compared to March’s level. As a result, in annual terms, consumer price growth decelerated from 11% in March to 8.5% in May. The progress in disinflation was achieved on the back of weak domestic demand (mainly as a result of subdued credit activity), a delay in utility tariff increases, correction of world commodity prices, stability of the Hryvnia exchange rate to the US Dollar and notable appreciation to the Euro6. While some further progress in disinflation may be seen in the coming months, we expect price growth acceleration to be about 13% at the end of the year due to natural gas and tariff adjustments, an increase in excises, revival of credit activity and faster growth of money supply.

The growth of monetary aggregates accelerated during April-May. In annual terms, monetary base and money supply grew by almost 12% and 11.5% respectively in May compared to moderate growth (in case of monetary base) and negative growth (in case of money supply) at the beginning of the year. The developments on Ukraine’s foreign exchange market and public finances were the primary causes of the acceleration, though a declining statistical base also played a role. The foreign exchange market remained calm during April-June 2010. Thanks to improved Balance of Payments, during these months foreign currency supply exceeded demand, generating appreciation pressures on the Ukrainian currency. However, the NBU allowed only minor appreciation to UAH 7.92 per USD, buying out the surplus. This allowed the Bank to replenish its international reserves to $29.5 billion at the end of June (up from $25.2 billion at the end of March 2010). A sizable NBU purchase of foreign currency resulted in corresponding injection of Ukrainian currency. However, the NBU allowed only minor appreciation to UAH 7.92 per USD, buying out the surplus. This allowed the Bank to replenish its international reserves to $29.5 billion at the end of June (up from $25.2 billion at the end of March 2010). A sizable NBU purchase of foreign currency resulted in corresponding injection of Hryvnia liquidity into the market. In addition, the repayment of domestic T-bills, which peaked during May-June of this year, and indirect NBU monetization of the budget deficit were other sources of monetary aggregates acceleration.

Better domestic liquidity conditions, however, were not accompanied by the revival of credit activity. On the contrary, from January to May 2010 the stock of commercial bank credit declined by almost 3%. Observing the improved macroeconomic situation and progress in disinflation, and trying to stimulate sluggish credit activity, the NBU lowered its discount rate at the beginning of June by 0.75 percentage points to 9.5%. Despite a contraction in domestic credit and public finances, the Bank made a further move to reduce interest rates and stimulate credit activity by cutting the discount rate by 1.0 percentage points to 8.5% at the beginning of July. This step, combined with the positive impact of improved Balance of Payments, helped to further moderate the appreciation rate of the Hryvnia.

International Trade and Capital
Ukraine’s Balance of Payments (BoP) has notably improved during April-May 2010. Favoured by growing world commodity prices (particularly on steel products), Ukraine’s export growth accelerated at double-digit rates.

*As Ukraine’s Hryvnia is de-facto pegged to the US Dollar, the Hryvnia exchange rate to Euro is determined by Euro/Dollar trend.
ports of goods reported a 30.6% yoy increase over the first five months of 2010. Though international commodity prices started cooling again in May 2010, they were still on a comfortable level for Ukraine’s exporters. Moreover, falling international prices on energy resources coupled with a lower price on imported natural gas, negotiated with Russia in April 2010, amid still weak domestic demand helped to contain imports. Thus, imports of goods were up by 29% yoy over January-May 2010. Though the pace of imports growth looks only marginally lower than of exports, it was achieved on a much lower statistical base effect (over the respective period last year, exports and imports of goods contracted by 44% yoy and 52.5% yoy respectively). As a result, stronger exports brought Ukraine’s current account into surplus to $0.3 billion for the first five months of the year compared to a $0.8 billion deficit over the respective period a year before.

An improving macroeconomic situation, better political climate and the government commitment to resume cooperation with the IMF helped maintain a solid degree of confidence and the willingness of foreign banks to continue to roll over Ukraine's external private debt. According to preliminary estimates of the NBU, five month external private debt roll-over ratios stood at 87% and 105% for commercial banks and the corporate sector respectively. At the same time, the latter number should be treated with some caution as the increase occurred partially as a result of past due private external debt payments. Despite recent deterioration on foreign capital markets due to Eurozone’s sovereign debt concerns, we believe Ukraine’s BoP is much less vulnerable this year. Given the new IMF program to Ukraine in place, whose successful negotiation will allow access to other IFIs’ financing, we believe Ukraine will be sufficiently cushioned against potential adverse external shocks.

### Ukraine’s Balance of Payments, selected indicators

<table>
<thead>
<tr>
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<th>5m 2009</th>
<th>5m 2010</th>
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<tbody>
<tr>
<td>Current account, $ billion</td>
<td>-0.8</td>
<td>0.3</td>
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<tr>
<td>Exports of goods, % yoy</td>
<td>-44.0</td>
<td>30.6</td>
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<tr>
<td>Imports of goods, % tot</td>
<td>-52.5</td>
<td>29.0</td>
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<tr>
<td>Capital &amp; financial account (analytical representation), $ billion</td>
<td>-5.8</td>
<td>1.3</td>
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<tr>
<td>Net FDI, $ billion</td>
<td>1.9</td>
<td>1.5</td>
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<tr>
<td>Debt roll-over ratio, %, o/w</td>
<td>80</td>
<td>93</td>
</tr>
<tr>
<td>Banking sector</td>
<td>74</td>
<td>87</td>
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<tr>
<td>Corporate sector</td>
<td>103</td>
<td>105</td>
</tr>
</tbody>
</table>

Source: NBU

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**June 2010**