Executive Summary

Thanks to the improving external environment and strengthening domestic branches and sectors reported better economic result in September. Industrial production growth accelerated to 10.2% yoy, led by machine-building, metallurgy and chemicals, though domestic-oriented food-processing, textiles and apparels industry also contributed. Retail sales turnover advanced by 5.1% over January-September, up from 4.6% yoy in the first eight months of the year, confirming robust recovery of domestic consumption.

As of October 26th, Ukraine had harvested about 39.5 tons of grain. Though lower than last year, this amount is almost 9% higher than the 10-year average. As the 2010 harvesting campaign started later than last year and intensified during September, the decline in agricultural output eased from 4.1% in January-August to 1.3% yoy in January-September. Despite an above-average harvest this year, the government authorities decided to impose restrictions to grain exports. Although officially grain export quotas were introduced in October, indirect customs restrictions were introduced at the end of July. As a result, exports and foreign trade related sectors (such as cargo transportation turnover) reported notable deceleration in September.

The ongoing economic recovery, the improving financial stance of Ukrainian enterprises, higher excises and surging imports helped government authorities to increase budget revenue collections. However, the catch-up in VAT refund reimbursement amid steady growth of budget spending led to notable widening of the state budget deficit during August-September. The reduction of the stock of VAT arrears to UAH 3 billion as of September was one of the IMF’s indicative targets for the government authorities to comply with for the second IMF tranche to be disbursed in December. Although the state budget deficit reached about 98% of the annual deficit target in January-September 2010, the annual deficit target still may be met.

A rise in administrative tariffs for the population in August, soaring international food prices and increased inflation expectations led to acceleration of inflation to 10.5% yoy in September. Since consumer prices grew by 4.1% in just two months while both external and domestic factors pressuring inflation up are likely to remain in force through the rest of the year, we revised our year-end inflation forecast up to 12% yoy in 2010.

Despite decelerating exports and surging imports, the current account deficit was moderate at about $0.8 billion for January-September 2010, while the sizable financial account surplus helped to further augment the NBU gross international reserves. The current level of international reserves helps alleviate pressure on the Hryvnia exchange rate, which is forecasted to remain in the range of UAH 7.9-8.0 per USD through the rest of 2010 and the beginning of 2011.
Economic Growth

September’s economic data revealed stronger performance of a number of sectors compared to the previous month. An improving external environment and strengthening domestic demand contributed to the rebound of Ukrainian industry from the summer months’ weaknesses. In September 2010, industrial output growth accelerated to 10.2% in annual terms, up from a monthly average of about 9.3% yoy during May-August. Benefiting from elevated world steel prices, metallurgy returned to growth, expanding by 14% yoy in September. Strong external demand for fertilizers underpinned a 20.8% yoy expansion in output in the chemical industry. Machine-building kept outperforming other branches. At the same time, the diminishing favorable base effect caused the industry to decelerate to 34.5% yoy in September (compared to a 42% yoy increase a month before).

Continuing solid growth of real monthly wages (up by 9.6% yoy over January-September) supported domestic-market-oriented food processing and the textile and apparel industry. In annual terms, output in these branches grew by 4.7% and 11.9% respectively. Retail trade turnover, often used to gauge the domestic consumption pattern, advanced by 5.1% yoy in January-September, up from 4.6% yoy in January-August. These indicators suggest that domestic consumption kept recovering at a fast pace in 3Q 2010. According to the Ukrainian national accounts, for the first two quarters of 2010, domestic consumption grew by a strong 5% yoy in 2Q 2010, up from a marginal 0.5% yoy increase in the previous quarter. The rebound in domestic consumption may have been explained by large social spending from the budget as well as improved consumer confidence amidst recovering economic activity and a more stable political situation. On the downside, however, robust growth in private consumption led to strong acceleration in imports (up by almost 25% yoy in real terms in 2Q 2010 versus meager 2.4% yoy a quarter before.)

Agriculture was another sector demonstrating notable improvement in September. Since this year’s harvesting campaign started later than last year, the decline in agricultural output eased to 1.4% yoy in January-September (compared to 4.1% yoy in January-August). As of October 26th, Ukraine harvested 39.5 tons of grain, about 9% higher than the average for the last 10 years. Despite an above-average crop this year, the Ukrainian authorities imposed restrictions on grain exports. The decision had a dampening impact not only on export growth but also on wholesale trade and cargo transportation. Turnover in the latter two sectors decelerated to 2.4% yoy and 8.7% yoy in January-September 2010 respectively, from 2.8% yoy and 9.5% yoy in the first eight months of 2010.

Despite stronger performance of a number of sectors in September, available economic data points to growth moderation in the second half of 2010. Indeed, according to preliminary NBU estimates, real GDP growth slowed to about 4% yoy in 3Q 2010, down from 5.9% yoy in the previous quarter. The slowdown was the result of weaker industrial sector performance during the summer months, lower agricultural output growth last year, introduction of agricultural export restrictions, slow recovery of domestic credit, acceleration of imports and a less favorable base effect. As most of these factors are likely to exist through the rest of the year, real GDP is forecast to grow by 4% yoy in 2010.

Fiscal Policy

As expected, with further economic recovery progress, budget revenue collections kept strengthening. According to Ministry of Finance data, revenues to the general fund of the state budget grew by almost 34% yoy in nominal terms over the first nine months of 2010, up from about 31% yoy reported for January-August. The gradually improving financial performance of Ukrainian corporate enterprises underpinned a 16.2% yoy increase in corporate profit tax proceeds over January-September this year. Robust growth in imports in recent months and a rise in excises on tobacco and alcohol brought in about 27% yoy and 35% yoy higher receipts from import duties and excises, respectively, over the period.

1Th While officially grain export quotas were introduced in mid-October, the government authorities introduced indirect restrictions on grain exports in July.
Despite generally stronger revenue collections, the catch-up in VAT refunds during August-September caused total state budget revenues to report only moderate growth of about 9% yoy in nominal terms over January-September (down from a 17.5% yoy increase observed for the first seven months of the year). Due to budget revenue shortfalls in 2009, the stock of VAT refund arrears almost doubled and reached about UAH 22 billion at the beginning of 2010. The government, however, kept building up VAT arrears in 2010. Further accumulation was due to the delay in the approval of the 2010 budget law (adopted only in April) and the development of the VAT refund program with the help of the IMF. The latter envisaged issuance of UAH 16.4 billion bonds to settle VAT refund arrears accumulated in 2009 and elaboration of the automatic VAT refund system. This program should have allowed Ukraine to reduce the stock of VAT refund arrears to just UAH 3 billion by September 2010 and to settle all arrears by the end of the year (both ceilings are indicative targets in the IMF program, whose first review is scheduled for mid-November 2010).

During August 2010, the government fully implemented the first part of the VAT refund arrears resolution program. At the same time, introduction of the automatic VAT refund system was delayed until beginning of next year. Simultaneously, the government notably increased cash settlement of arrears during August-September. As a result, according to Prime Minister Azarov, the stock of VAT refund arrears was reduced to UAH 2.9 billion as of the beginning of October 2010, fully in compliance with the IMF requirement. Despite this improvement, the actual VAT refund arrears might be higher. Several government officials announced that unrefunded VAT claims stood at about UAH 10 billion as of September. The difference between the IMF and the national definition of unrefunded VAT claims may explain this divergence. According to the IMF definition, the stock does not include unsettled VAT claims within 60 days after they were submitted to the state-tax administration (STA) as well as claims rejected by the STA but appealed in courts.

In contrast to budget revenues, state budget expenditures kept growing at a robust pace, expanding by a nominal 26.7% yoy in January-September 2010. The rise in expenditures was driven by higher spending on public sector wages (up by 12% yoy), social transfers to the population (up by 61% yoy), improved financing of infrastructure projects (capital expenditures grew by 88% yoy on a low base effect) and increased public debt service. Following sharp deterioration of public finances in 2008–2009, the stock of Ukraine’s public and publicly guaranteed debt grew from less than 13% of GDP at the end of 2007 to about 33% of GDP in 2009. Correspondingly, public debt service payments were more than twice as high in January-September 2010 as the year before. With further government borrowing this year (the next IMF tranche in December, other financing from IFIs), total public and publicly guaranteed debt may reach 40% of GDP in 2010. This level of public debt is not considered high by international standards. However, its rapid growth as well as the higher public debt service burden for this year and future budgets impose some risks for economic recovery and sustaining economic growth. The resumption of the cooperation with the IMF and the government’s firm commitment to the program requirements were key in reducing these risks.

As the growth of budget expenditures notably outpaced that of revenues during August-September, the state budget deficit widened to UAH 52.8 billion (about $6.7 billion) for January-September 2010. The nine month deficit represented almost 97.6% of the full-year state budget deficit target (UAH 54.1 billion). As this rapid widening was primarily caused by large VAT refunds, we believe the year-end target may still be met.
**Monetary Policy**

Following an unusual surge for August of 1.2% month-over-month (mom), consumer inflation climbed 2.9% mom in September, a 12-year record high rate of increase for this month. In annual terms, inflation accelerated to 10.5% in September, up from 8.3% a month before. Unlike the previous month, when the surge in inflation was mainly explained by a rise in utility tariffs, September’s acceleration in inflation was mainly driven by food prices (up by 13.5% yoy) and hard liquor and tobacco (up by 22% yoy). While the price increase for the latter group was primarily driven by an increase in excises on these products, food prices were pressurized by soaring international prices, domestic supply rigidities and increased inflationary expectations amid lower agricultural output this year.

Concerns over rapid growth of food prices were likely among the main reasons behind the Ukrainian government’s decision to impose grain export quotas despite a relatively good harvest this year. Thus, just in August-September, prices on bread and bakery products advanced by almost 5%. Although the introduction of the grain export ban, NBU measures to absorb excess liquidity from the market and still subdued credit activity may help to contain consumer price growth, recent acceleration and high external demand made us raise our year-end inflation forecast to 12% for 2010.

Though the impact of monetary aggregates growth in acceleration of inflation was relatively limited, the NBU was actively absorbing excess liquidity from the market by using its certificate of deposits facility. The monthly size of its sterilization operations on average was almost twice as high in 3Q as in the first half of the year. Due to a seasonal increase in domestic demand for foreign currency in September, causing greater volatility on the interbank foreign exchange market, the NBU intervened with a sale of $670 million to support the Hryvnia exchange rate, allowing only moderate depreciation to UAH 7.94 per USD. Liquidity sterilization operations and the NBU sale of foreign currency caused the monetary base to decline by 1.7% mom in September. At the same time, due to continuing robust growth of deposits (up by 3.4% mom), money supply was up by 2.3% mom that month. In annual terms, the growth of money supply accelerated to 21%, while the monetary base decelerated to 18%.

Amid robust deposit growth (the stock of deposits is approaching pre-crisis levels), reduction of the NBU discount rate, moderate commercial bank progress in cleaning up their nonperforming loan portfolios as well as a solid economic recovery, commercial bank lending activity started to pick up. Bottoming out in June 2010, bank loans to the economy grew by about 1% per month during the third quarter. As a result, as of late September, the stock of bank loans exceeded the year-end-2009 level by 0.5%. The improvement came mainly on account of domestic currency loans, which expanded by 7.5% from January to September, while loans in foreign currency declined by 6.2%. The revival of bank lending will support economic recovery in the country. However, it may add to inflationary pressures. Hence, tighter NBU management of excess liquidity in the banking system and reinstatement of a 20% reserve requirement on commercial banks’ short-term borrowings from abroad beginning in October may signal a gradual shift towards stricter monetary policy.

**International Trade and Capital**

During September 2010, Ukraine exports of metallurgical products, machinery and chemicals kept growing at a fast pace, benefitting from increases in world steel prices, strong Russian demand for Ukraine’s heavy-duty vehicles and locomotives, and robust overseas demand for fertilizers. In value terms, exports of the respective commodity groups, which account for about 62% of total merchandise exports, were up by 33% yoy, 38% yoy and 49% yoy respectively. However, the growth of total exports of goods decelerated to 25% yoy in September, down from 32.5% yoy average growth for July-August. The deceleration is primarily attributed to almost 8% yoy lower exports of agricultural products. Although Ukraine officially introduced grain export restrictions only in October, exporters of agricultural products have faced indirect customs restrictions since the end of July.

In contrast to exports, the growth of commodity imports further accelerated to 42.4% yoy in September, up from about 41% yoy in August. While larger volumes of imported energy resources (up by 65% yoy) contributed the most to total import growth, intensifica-
tion of imports of transport vehicles and other machinery (up by 48% yoy) may be another indicator of robust recovery of domestic demand. Due to surging imports and slower growth in exports, the foreign trade deficit in goods over August-September amounted to almost $2 billion, only marginally higher than the cumulative deficit for the first half of the year. However, despite a high foreign trade deficit, September's current account deficit narrowed to $0.3 billion, down from $0.6 billion in August. The improvement was mainly the result of a higher foreign trade surplus in services, achieved mainly on account of higher proceeds from natural gas transit, as well as lower dividend payments from Ukraine.

The nine-month current account deficit, which stood at $0.8 billion, was more than covered by the large surplus in the financial account. In September 2010, the surplus in the financial account grew to $1.5 billion despite higher external debt repayments that month as well as increased domestic demand for cash foreign currency. The surge in the financial account surplus is explained by placement of $2 billion sovereign Eurobonds in mid-September and a high private external debt roll-over ratio. The latter stood at 106% in September, up from about 86% a month before. Large inflow of foreign capital allowed the NBU to further accumulate its gross international reserves, which amounted to $34.7 billion at the end of September, a level sufficient to cover 5.8 months of imports. Though Ukraine's external debt financing needs remain significant (about $42 billion from June 2010 to May 2011, according to NBU external debt data by residual maturity), the current level of NBU reserves and high external debt roll-over should cause the Hryvnia exchange rate to remain in the range of UAH 7.9-8.0 per USD through the rest of 2010 and early 2011.

Other Developments and Reforms Affecting the Investment Climate

On October 1st, the Constitutional Court of Ukraine ruled that the changes to the Constitution adopted in 2004 were unconstitutional due to the violation of the procedures for their approval. The 2004 amendments to the Constitution reduced the president's power by transferring the power to appoint the prime minister and several key ministers (defense and foreign affairs), though on the president's recommendation, to the parliament. The other ministerial appointments were in the hands of the prime minister. The constitutional reform of 2004 was not finalized as it allowed for overlapping responsibilities between the President and the Prime Minister, leading to a number of political crises and short election cycles, and hindering reforms.

The Constitutional Court decision returned Ukraine to its 1996 constitution, and thus to a presidential republic. According to the original version of Ukraine's 1996 Constitution, the President has the right to appoint the Prime Minister (though parliamentary approval is still needed) and other members of the government. Moreover, the president can decide on the resignation of the prime minister without the consent of the parliament and has the right to rearrange any of the central executive organs according to the prime minister's recommendation. In addition, the president can veto any government resolution. While these changes raised concerns about too much political power in the hands of one person, power centralization will reduce tensions inside the executive branch, which may facilitate the decision-making process and improve implementation of structural reforms and policy measures. In the short-term, however, the Court's decision may lead to parliamentary elections in March 2011.