Executive Summary

In 2010, the Ukrainian economy recovered at about 4.2% yoy from a 14.8% yoy crisis-induced decline in 2009. The recovery was led by exports, private consumption (which surprised on the upside) and strong inventory rebuild. Additionally, the recovery was broad-based among sectors with only construction and agriculture reporting small declines. A 1% decline in agricultural output was registered on a high relative base, as the 2010 grain harvest was 9% higher than average for the last 20 years. The economy is forecast to make further gains in 2011, though at a slower pace. Some deceleration to about 4% yoy in 2011 will come as a result of slower growth in private and government consumption, principally due to notable fiscal tightening.

Although official data on 2010 full-year budget execution is scarce, other government sources indicated that though the state and local budget deficit may have been close to the planned amount, Naftogaz and Pension Fund deficit targets were missed. The broad fiscal deficit is estimated to have reached 7.2% of GDP, above the IMF target of 6.5% of GDP. The higher fiscal deficit was mainly the result of below-target revenue growth as well as some delays in implementing fiscal consolidation measures. Given the under-fulfillment of budget revenues in 2010, enforcement of tax reform and politically painful measures to be implemented in 2011, successful execution of this year’s budget looks very challenging and may require additional retrenching of government expenditures. Though some delays are possible, we believe the government will generally follow the IMF requirements given that continuation of the program pays a substantial confidence building role for the Ukrainian economy.

To a large extent thanks the presence of the IMF program, Ukraine enjoyed an impressive 109% external debt roll-over ratio in 2010, which allowed them to successfully service foreign debt and augment NBU gross international reserves to $34.5 billion. At the same time, external debt service payments are projected to stay high during this and the next few years. Hence, the country needs to keep foreign investors’ confidence high to secure its fragile external position. At the same time, Ukraine is unlikely to attain similar to 2010 debt rollover ratios in the future. Forecast acceleration of consumer inflation to about 12% in 2011, much higher than in Ukraine’s main trading partner countries, will also pressure the Hryvnia to depreciate. Assuming also the NBU’s gradual shift towards a more flexible exchange rate regime, the Hryvnia is projected at about UAH 8.5 per USD at the end of 2011.
Economic Growth

Economic data showed the Ukrainian economy made further gains at the end of 2010. Industrial production rose by 12.5% in December 2010 compared with December 2009. December’s expansion in industrial output was primarily led by export-oriented metallurgy, chemicals and machinery as well as energy production. Although world steel prices weakened in December, Ukraine’s metallurgical industry has risen by 12% yoy, further up from 10.9% yoy a month before. The increase in production may be explained by good prospects for the industry in the near term amid an anticipated further rise in world steel prices, pressured upwards by surging iron ore prices, and projected strengthening of external demand (due to robust growth in Asia, Africa and Russia). Machine-building finished the year on a strong note, with output up by almost 39% yoy in December and 34.5% yoy for the whole year. The expansion was mostly export-led, as the industry benefited from a rebound in investment demand in Russia, the main export market for Ukraine’s heavy machinery, and exploration of new markets (such as the Czech Republic, a joint project with which boosted Ukraine’s production of public transportation vehicles).

Growing world demand for food products amid supply shortages due to export restrictions in several key exporting countries (i.e., Russia, Ukraine) stimulated demand for fertilizers. As a result, Ukraine’s chemical industry gained 33% yoy in December 2010 and 21.5% yoy for the whole year. Recovering economic activity and volatile weather (with extreme temperatures in summer and at the beginning of December) underpinned a 9.5% yoy increase in production of electricity, gas and water in 2010. Strong rebound in private consumption since the second quarter of 2010 (primarily on account of an almost 10% real wage increase in 2010) as well as more expensive imports supported domestic food processing and light industries. Production in these industries was up by about 3% yoy and 8% yoy in 2010, respectively. As a result, the full-year advance in total industrial production stood at a solid 11% yoy.

Favored by buoyant growth in industry and exports, wholesale trade and cargo transportation turnover grew by 0.4% yoy and 6.4% yoy respectively. At the same time, the pace of growth in these sectors has notably weakened in the second half of the year, first due to a slowdown in international trade during the summer months, then as a result of grain export restrictions. Although Ukraine collected an above-average grain harvest in 2010, the latter was introduced to contain domestic inflation pressured by surging world food prices. According to final data, Ukraine harvested 39.2 million tons of grain in 2010, still 9% higher than average for the last 20 years. In relative terms, however, gross crop production (including sunflower seeds, sugar beets, etc.) fell by almost 5% yoy in 2010 as the 2009 harvest was the third largest on record. At the same time, thanks to a 4.5% increase in animal breeding, the agricultural sector reported a 1% yoy decline in output.

With better budget financing of infrastructure projects and some revival of credit activity, construction sector performance notably improved in the second half of the year. Still, for the whole year, the volume of construction works was 5.4% lower than in the previous year. In contrast, retail trade turnover recovered at an encouraging 7.6% yoy in 2010. Given sector development, real GDP is estimated to have grown by 4.2% yoy in 2010.

Looking ahead, economic growth in Ukraine is projected to moderate to about 4% yoy in 2011, according to our revised forecast. While the growth outlook for Ukraine’s main export-destination countries and prospects for world commodity prices (steel, fertilizers, etc.) are favorable, other sources of growth are likely to weaken. Indeed, private consumption will continue recovering in 2011, benefiting from better economic and political stability. At the same time, due to slower real wage growth, higher utility costs and excise taxes as well as still subdued credit activity (particularly retail credit), private consumption growth will lose momentum. Committed to reducing the general fiscal deficit to 3.5% of GDP in 2010, down from about 7.2% of GDP in 2010 (according to preliminary data), the government will have to notably tighten expenditures.
On the upside, the growth will be supported by a forecast strong rebound in fixed investment related to Euro 2012 football championship infrastructure projects. However, as the inventory rebuild cycle, impressive in 2010, is likely to fade this year and credit activity will remain weak, the net impact on economic growth may be mixed. In addition, continuing recovery in private consumption (though at a slower pace) and buoyant investment demand will keep imports high. The speed of structural reforms may be on both risk sides for the current forecast. At the end of 2010, the government began or announced a number of reform measures, such as public administration, pension, tax reforms, and anti-corruption efforts. At the same time, the reform progress is very uncertain. Given the election-free year, 2011 may become a year of major economic reforms in the country. However, many of them (such as pension reform, utility sector reform, etc.) are politically painful. As of the beginning of the year, available information indicates reform progress is likely to be moderate this year (the pension reform measures, expected to have been announced and approved at the end of 2010, are still pending; there is little information on anti-corruption strategy; it is unclear whether the government will initiate comprehensive public administration reform with functional and operational reviews, public service reform, etc.).

Fiscal Policy

After the sharp crisis-related deterioration in 2009, restoring public finances and debt on a sustainable path is one of the main macroeconomic challenges for Ukraine in the medium term. While the presence of the IMF program, secured in mid-2010, played a substantial confidence building role for the Ukrainian economy, public finances were under strain in 2010 and are likely to remain challenging in 2011. Effective fiscal consolidation measures to meet the targeted 3.5% of GDP for a broad fiscal deficit in 2011 are currently the main uncertainty in the country as many of these measures are politically sensitive to implement.

At the end of December 2010, the 2011 state budget law was approved based on new tax rules with a deficit target of 3.1% of GDP, fully in compliance with IMF requirements. The impact of the new Tax Code, which took effect at the beginning of this year, on budget revenues is expected to be rather neutral. The likely revenue shortfalls due to a 2 percentage point reduction in the corporate profit tax rate to 23% since April 1st, 2011 and new tax breaks are expected to be largely offset by a rise in excises on alcohol, tobacco and gasoline, higher oil and natural gas rent payments and notable narrowing of the simplified taxation system. Following massive entrepreneur protests, the main provisions of the simplified taxation system were preserved. However, the final version of the new Tax Code contained an important revision, which will substantially limit the scope of the system. In particular, the costs of goods and services (except IT) acquired from private entrepreneurs on a simplified taxation system will be non-deductible for companies on a general taxation system. In addition, the government is going to revise the system rules again this spring. At the same time, budget revenue growth is likely to be constrained in 2011 as the economy may require some time to adjust to new tax rules. As a result, the government projected fiscal revenues to increase by a moderate 11.4% yoy in nominal terms to UAH 281.5 billion ($35.2 billion) in 2011.

Correspondingly, to meet the deficit target the government concentrated on fiscal austerity measures. State budget expenditures are set to increase by about 4% yoy in nominal terms. Such a modest increase will be achieved by containing social spending (e.g., average wage is projected to increase by about 4% yoy in real terms, down from 10% yoy in 2010), implementing public reform measures (the first stage, which began at the end of 2010, envisages an about 30% reduction in the size of government apparatus), further efforts to rebalance Naftogaz Ukrainy. The latter will include a rise in natural gas tariffs to population by another 50% in April 2011 and faster pass-through of higher energy prices on final consumers. Announced pension reform measures (such as introduction of a cap on pension benefits and gradual increase in pension age for women) will also help to contain the growth of budget expenditures, though the full impact will be felt in the medium term.

While the package of the austerity measures signals a strong government commitment to bringing the budget deficit under control, which is necessary to maintain Ukraine’s international credibility, it may be very challenging for the government to meet the target in 2011. The target looks quite ambitious given that the 2010 broad fiscal deficit was likely above the targeted 6.5% of GDP. Although full details are still not available, preliminary data showed the state and local budgets deficit may have stood very close to the target. Thus, state budget revenues amounted to UAH 240.5 billion ($30 billion), or 5.7% lower than budgeted. Below target proceeds were
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achieved despite overall realistic macroeconomic assumptions: higher economic growth (4.2% yoy versus 3.7% projected in the budget) compensated for lower inflation (9.1% yoy versus 13.1% yoy projected in the budget). Underestimation of the amount of taxes paid in advance in 2009, generally slower fiscal recovery than overall economic activity\(^1\), as well as legal loopholes allowing for tax avoidance\(^2\) were likely the main reasons of budget revenue shortfalls in 2010. At the same time, the government authorities likely strictly controlled expenditures at the end of the year to meet the targets. However, government sources have indicated that Naftogaz and Pension fund of Ukraine ended the year with higher than planned deficits. As a result, broad fiscal deficit may have amounted to 7.2% of GDP in 2010.

Given that actual budget revenues were under-fulfilled in 2010, there is a risk that the 2011 budget revenue target may also be over-estimated. In addition to the above mentioned reasons, the risk of below-target execution may stem from the fact that the government is strongly counting on the de-shadowing of the Ukrainian economy following the approval of the new Tax Code. Although the new Code streamlines tax legislation, reduces corporate profit tax and provides for tax exemptions, the desired de-shadowing still may not be realized. For it to happen, notable progress in tax administration reform is needed as the cumbersome, non-transparent and time-consuming process of paying taxes rather than high taxes per se is causing the most complaints from the business community. However, to secure more revenues to the budget at the end of the year, tax authorities increased administrative pressure on business. Coupled with stricter tax administration rules envisaged in the new Tax Code, this may stimulate tax evasion. Hence, additional government retrenchment measures to meet the 2011 budget deficit target are likely to be the main issue of discussions with the IMF this February, when the mission comes to complete the second review under the SBA to Ukraine. The negotiations are likely to be tough as many fiscal tightening measures are politically painful. However, if secured, Ukraine may become one of the most successful countries performing fiscal consolidation.

Monetary Policy

Ukraine ended 2010 with consumer inflation at 9.1% yoy, the lowest rate for the last six years. While the progress in reducing inflation was broadly anticipated, the year-end inflation was much lower than expected. This was mainly because monthly consumer price growth rates during the last quarter of the year were the lowest on record since 1996. Despite significant pressure from surging international food prices and higher energy prices, consumer prices grew by only 1.6% from October to December, mainly on account of unusual fruit and vegetable deflation in October-November (attributed to government administrative measures) and a delay in utility tariffs adjustment after a 50% increase in natural gas tariffs to utility companies. In 2011, inflation is projected to accelerate to about 12%, prompted by scheduled another 50% rise in natural gas tariffs since April 2011, faster pass-through of higher energy prices to utility tariffs (heating, hot water, and electricity), higher excises on gasoline and elevated world energy prices. Higher utility and transportation costs will eventually be transmitted to food prices and the cost of other consumer goods and services.

In 2010, the impact of money supply growth on consumer price inflation was rather weak. The monetary base expanded by 15.8% yoy in 2010, very close to the IMF target of 15.4% yoy. The pace of monetary base growth notably moderated during the last three months of the year, which may be attributed to the NBU resuming foreign currency interventions on the interbank market since September 2010 and measures to tighten banking sector liquidity. Thus, cash balances on commercial banks correspondent accounts declined by about 16% from September to the end of the year. Surging imports amid slower export growth and high population demand for foreign currency pressured the Hryvnia exchange rate to depreciate. To support the Hryvnia exchange rate, the NBU spent $2.2 billion on a net basis during the last four months of the year. As a result, the Hryvnia marginally depreciated from UAH 7.89 per USD at the end of August to UAH 7.96 per USD at year end. Moderation of monetary base growth and still weak bank credit activity allowed containing money supply growth at about 22.5% yoy in the last four months of 2010.

Credit activity remained weak throughout 2010, with signs of revival observed in the second half of the year. Although banking system liquidity notably improved (bank deposits grew by a solid 26.3% yoy, the NBU restructured crisis-induced refinancing loans to a number of banks, lowered its discount rate by 2.5 percentage points to 7.75% pa, etc.), commercial banks stayed reluctant to resume credit activity. The stock of bank credit grew by a modest 1% yoy in 2010. High credit risks and a high share of non-performing loans (NPLs) undermined bank credit and profits. The share of NPLs, broadly defined (including substandard loans) was estimated at about

\(^1\)Typically employment and recovery in corporate revenues lag behind economic revival.

\(^2\)Using loopholes in the Ukrainian legislation, at the end of May 2010 Livella company, a subsidiary of a joint company with foreign direct investments, won a court decision allowing it to import crude oil and gasoline products without paying excises and VAT. According to various estimates, the company gained about 60% share of all crude oil and gasoline imports to Ukraine since August 2010, when it actively started its operations.

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<table>
<thead>
<tr>
<th>Year</th>
<th>CPI</th>
<th>GDP Growth</th>
<th>Hryvnia Depreciation Impact</th>
<th>Credit Stock</th>
<th>Money Supply</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>5%</td>
<td>32%</td>
<td>72%</td>
<td>0%</td>
<td>48%</td>
</tr>
<tr>
<td>2008</td>
<td>6%</td>
<td>48%</td>
<td>64%</td>
<td>16%</td>
<td>32%</td>
</tr>
<tr>
<td>2009</td>
<td>8%</td>
<td>56%</td>
<td>32%</td>
<td>16%</td>
<td>24%</td>
</tr>
<tr>
<td>2010</td>
<td>8%</td>
<td>48%</td>
<td>16%</td>
<td>32%</td>
<td>0%</td>
</tr>
</tbody>
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Source: State Statistics Committee, The Bleyzer Foundation
40-45% in 2010. With the continuing shift in the NBU financial sector policies from containing the deterioration in the banking sector towards restoring bank credit supply (through simplification of NPLs resolution process, introduction of better risk management practices and liquidity support), credit growth is forecast to increase in 2011, though very gradually as the above-mentioned measures will take time to be implemented. However, as the credit growth still will be stronger than in the previous year, so will the money supply growth, contributing to the acceleration in inflation in 2011.

International Trade and Capital

Stronger than expected world economic growth in 2010 and favorable international prices for Ukraine’s traditional export commodities (steel, iron ore, fertilizers, agricultural products) were supportive to Ukraine’s exports of goods, which grew by a robust 29% yoy in $ terms, according to preliminary data. Export of metallurgical products (+35% yoy) traditionally was the largest contributor to total merchandise export growth, followed by mineral products (+80% yoy), locomotives and other transport vehicles (+110% yoy) and chemicals (+33% yoy). Due to introduction of grain export restrictions, export of agricultural products grew by a modest 4.4% yoy in 2010, while total export growth notably decelerated in the second half of the year. In contrast, imports rebounded strongly since the second quarter of the year, spurred by recovered consumer demand as well as elevated world energy prices. As the growth of imports (+35.5% yoy) outpaced exports, the trade deficit in goods widened to $8.4 billion in 2010, almost twice as high as in 2009. Although a higher trade surplus in services and workers’ remittances partially compensated for that deterioration, the current account balance ended with a larger deficit of $2.6 billion, or 1.9% of estimated full-year GDP. In 2011, despite a generally favorable outlook for Ukraine’s exports, the current account gap is projected to further increase to 2.5% of GDP as stronger investment demand and higher energy prices will keep the growth of imports above exports.

Despite widening, the current account deficit is not a cause of concern as it was and will be securely covered by FDI ($5.7 billion in 2010 and about $7 billion forecast in 2011). At the same time, Ukraine’s external position remains fragile due to high external debt service needs. In 2010, Ukraine enjoyed a very high external debt roll-over ratio (109%), considerably above expectations. To a notable extent, this level was achieved thanks to resumption of cooperation with the IMF, which not only provided Ukraine with still scarce foreign financing but also helped to maintain investor confidence. This allowed Ukraine to augment its gross international reserves to $34.6 billion at the end of 2010, up from $26.5 billion in 2009. In the current and next few years, external debt service payments are projected to stay high as Ukraine is no longer a low-debt country. Gross external debt (public and private) stood at $111.5 billion as of September 2010, about $43.5 billion of which is due within one year. Hence, the continuation of the IMF program will remain key to securing debt roll-over at high levels. At the same time, Ukraine is unlikely to enjoy debt rollover ratios similar to 2010 in the future. In addition, inflation will remain much higher than in its main trading partner countries, causing the gradual loss in competitiveness, restored during the crisis years. Assuming also the NBU gradual shift towards a more flexible exchange rate regime, the Hryvnia is projected to moderately depreciate to UAH 8.5 per USD by the end of 2011.