Executive Summary

In April 2011, the Ukrainian economy remained on a path of solid growth. Unlike at the beginning of the year, however, the growth was supported by strengthening domestic consumption and investment activity, while export-oriented sectors reported a deceleration in output due to more challenging external conditions. Thus, industrial production growth slowed to less than 5% in April, led by weaknesses in metallurgy (up by only 3% yoy in April), machine-building (up by 13.6% yoy vs. 26.8% yoy in 1Q 2011) and coke- and oil-refining (-20.7% yoy). Weaker industry performance also explains the growth moderation in wholesale and cargo transportation sectors. However, buoyant real wage growth, accelerating consumer activity and improving consumer sentiment underpinned acceleration in retail trade and non-financial services. Higher earnings of Ukrainian enterprises and sizable budget financing of infrastructure projects supported a revival in the construction sector.

The economy is forecast to grow by 4.5% yoy in 2011. Although private consumption is likely to increase faster than initially projected thanks to the government’s recent upward revision of social spending, surging imports may exert a toll on growth. Indeed, during April, export growth eased to 32% yoy due to world commodity price growth and weaker Russian demand for Ukraine’s capital goods. Though imports also decelerated amid lower volumes of natural gas imports, the current account deficit reached $1.6 billion over the first four months of the year, in contrast to the small surplus in the corresponding period last year. In 2011, the current account is forecast to widen to about 3% of GDP. Furthermore, stronger domestic demand, due to higher social spending and resuming bank credit to households, is likely to keep inflation high.

Over January-April 2011, the wider current account deficit was more than covered by a significant surplus on the capital and financial account, thanks to privatization of Ukraine’s fixed-line telecommunications monopoly, Ukrtelecom, and a number of successful Eurobonds placements by the state and corporate sector. This also allowed the NBU to augment its gross international reserves and keep the Hryvnia exchange rate virtually stable. However, due to high external debt repayments, widening current account deficit and uncertainty over resumption of IMF program, the second half of the year may see higher exchange rate volatility and Hryvnia depreciation pressures.

The Ukrainian government seems committed to keeping the broad fiscal deficit at 3.5% of GDP in 2011. Due to delays in natural gas tariff hikes to households and pension reform implementation, Naftogaz and Pension Fund imbalances may be higher than initially planned. To maintain the broad fiscal deficit at the targeted level, Ukrainian authorities announced that the consolidated budget (state, local and official Pension Fund balances) would be balanced. Although budget revenues surprised on the upside during January-April, a zero consolidated budget deficit appears to be problematic considering the recent government decision to raise public sector wages, excise tax cuts (though temporary), reduction of the corporate tax rate, small business privileges, and legislative initiatives to re-instate a simplified taxation system.

Due to the lack of implementation of a number of IMF requirements (natural gas tariff increases, pension reform and additional measures to reduce the budget deficit), there is a risk that the IMF program may be suspended after June. However, the government seems aware that, given existing vulnerabilities (high external debt, fragile banking sector, high fiscal deficit and widening current account deficit), the continuation of the IMF program is essential for Ukraine. The program not only gives access to scarce and cheap foreign financing, but also serves an anchor for sound economic policies and reforms, which is necessary to maintain the confidence of international investors. Therefore, at the end of May-beginning of June, the government expedited the implementation of other IMF requirements, which increases the chances IMF program will be resumed in July-August this year.

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MACROECONOMIC SITUATION

May 2011

Olga Pogarska, Edilberto L. Segura

• A more challenging external environment caused a slowdown in industrial production in April; however, growth remained solid thanks to strengthening domestic demand.
• The state budget deficit widened to UAH 4 billion in January-April as the growth in expenditures accelerated.
• To commit to the broad fiscal deficit target of 3.5% of GDP, the government announced that the consolidated budget would be balanced in 2011. However, no details of likely fiscal adjustment measures were provided. Given the recent initiatives to increase wages and reduce excise taxes, as well as the revenue shortfall due to implementation of the Tax Code, balancing the consolidated budget looks very challenging.
• The lack of implementation of IMF requirements put IMF program resumption at risk. However, the Ukrainian authorities seem determined to revive the program.
• The current account deficit narrowed in April, but the four-month deficit reached $1.6 billion compared to a small surplus in January-April 2010.
• The capital and financial account reported a large surplus over the period. However, the risks to BoP may increase in the second half of the year if the IMF program goes off track.

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Economic Growth

April’s real sector data shows that the Ukrainian economy remained on a path of solid growth, supported by domestic consumption and robust investment activity. At the same time, the industrial sector, a strong growth area in the first quarter of 2011, reported a notable slowdown in output production in April. As the sector holds almost 25% of GDP and is closely linked with transportation and wholesale trade, 2Q is likely to see a moderation in real GDP growth compared to the robust 5.2% yoy increase in the previous quarter, according to preliminary data. For the whole year, the economy is forecast to grow by 4.5% yoy.

By sector breakdown, retail trade and construction were the leading growth sectors in April. Retail trade turnover, often used to gauge domestic consumption patterns, grew by 15% yoy in January-April, a marked acceleration from the 13.5% yoy increase in the first three months of the year. Hence, private consumption likely grew robustly over January-April 2011, supported by an 11% yoy increase in real wages over the period and improving consumer sentiment.¹ The value of non-financial services grew by almost 17% yoy in the first four months of the year. Higher investments in non-residential building construction and infrastructure projects underpinned an 11.6% yoy increase in the real value of construction works over January-April 2011. An almost 12% yoy increase in fixed assets investments in 1Q 2011, according to State Statistics Committee of Ukraine, may be attributed to better financing conditions (declining bank credit interest rates and reviving bank credit activity), stronger earnings of Ukraine’s enterprises as well as higher public financing of infrastructure projects ahead of the Euro-2012 football championship.

The food and beverage industry showed signs of improvement, although its production was still down by 2.2% yoy in April (-2.7% yoy in March 2011). As in previous months, domestic supply shortages and higher excise taxes on alcohol were the primary reasons for the continuing decline. Thus, the change in the allocation mechanism and a reduction of government support to milk producers² resulted in lower milk supply for processing. Indeed, production of milk fell by 2% yoy over January-April. As a result, production of dairy products fell by almost 10% yoy in April. Lower production of milk and a backlog in spring crop sowing (as unfavorable weather caused a later start of the campaign) were among the primary reasons of growth moderation in agriculture to 4% yoy in January-April compared to 5.3% yoy in 1Q 2011. At the same time, the food processing industry was supported by better performance of flour-milling, bread and bakery branches after several months of weakness caused by flour supply shortages at the beginning of the year, and the meat processing industry. Production of the latter grew by almost 15% yoy, taking advantage of the good growth momentum maintained in animal and poultry husbandry.

Output of coke and oil-refining was almost 21% yoy lower in April 2011 mainly due to a 32% yoy reduction in production of refined petroleum products. Domestic oil-refining suffers from outdated technologies that do not achieve a high depth of oil refining, which makes domestic oil-refining too costly amid high world crude oil prices. In addition, Ukraine’s oil refineries, which are paying export duty on crude oil imports from Russia, are in a disadvantaged position compared to Belarusian and Russian companies, which are getting significant oil price discounts.

Unlike domestic-driven industries and sectors, output growth in most export-oriented industries slowed during April 2011. Output growth in metallurgy eased to 3.1% yoy over the month under review amid less benign external conditions for steel exports. The end of the restocking cycle, MENA region turbulence and a powerful earthquake in Japan were the primary causes of weakening global steel demand since mid-March. Correspondingly, global steel prices started to decline rapidly. At the same time, with the world moving

¹According to GFK-Ukraine, Consumer Confidence Index grew by 6 percentage points in April, following a rapid decline during the first three months of the year.
²The new Tax Code envisaged a lower amount of state support to milk producers. In addition, the mechanism of state support allocation was also changed. Before, milk producers were subsidized by receiving VAT directly from milk processors. Since the beginning of 2011, the scheme was changed to a more complicated mechanism, when VAT is first accumulated to the special fund of the state budget and then is allocated to producers. The rural population, which accounts for 78% of total milk producers, was the most severely affected by the changes in the state support system.
³The average depth of oil refining in Ukraine is estimated at about 65%.

Real Sector Performance of Ukraine % yoy

<table>
<thead>
<tr>
<th>Sector</th>
<th>Jan-Apr 2011</th>
<th>2010</th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agricultural output</td>
<td>4.9</td>
<td>-1.8</td>
<td>17.1</td>
<td></td>
</tr>
<tr>
<td>Industrial output</td>
<td>12.6</td>
<td>11</td>
<td>-21.9</td>
<td>-3.1</td>
</tr>
<tr>
<td>Construction works</td>
<td>11.6</td>
<td>21.2</td>
<td>-5.4</td>
<td>15.8</td>
</tr>
<tr>
<td>Domestic trade turnover</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wholesale trade</td>
<td>3.2</td>
<td>4.3</td>
<td>-19.3</td>
<td>-6</td>
</tr>
<tr>
<td>Retail trade</td>
<td>14.9</td>
<td>2.1</td>
<td>-17.4</td>
<td>18.1</td>
</tr>
<tr>
<td>Restaurants</td>
<td>8.5</td>
<td>-3.5</td>
<td>15.6</td>
<td>4.6</td>
</tr>
<tr>
<td>Transportation turnover</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Industrial Production Growth by Select Branches % yoy

<table>
<thead>
<tr>
<th>Branch</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>11</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food processing</td>
<td>140%</td>
<td>35%</td>
<td>3.2</td>
<td>4.3</td>
</tr>
<tr>
<td>Chemicals</td>
<td>175%</td>
<td>15%</td>
<td>0.4</td>
<td>0.4</td>
</tr>
<tr>
<td>Metallurgy</td>
<td>210%</td>
<td>40%</td>
<td>14.2</td>
<td>8.7</td>
</tr>
<tr>
<td>Machine-building</td>
<td>120%</td>
<td>30%</td>
<td>3.5</td>
<td>5.4</td>
</tr>
<tr>
<td>Mining</td>
<td>140%</td>
<td>50%</td>
<td>6.4</td>
<td>18.1</td>
</tr>
<tr>
<td>Non-financial</td>
<td>110%</td>
<td>20%</td>
<td>7.6</td>
<td>4.3</td>
</tr>
</tbody>
</table>

Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

World Steel and Fertilizer Price Indices % yoy

<table>
<thead>
<tr>
<th>Index</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>11</th>
</tr>
</thead>
<tbody>
<tr>
<td>Steel Price Index</td>
<td>110%</td>
<td>70%</td>
<td>30%</td>
<td>210%</td>
</tr>
<tr>
<td>Fertilizer Price Index</td>
<td>150%</td>
<td>105%</td>
<td>40%</td>
<td>70%</td>
</tr>
</tbody>
</table>

Source: National Bank of Ukraine, World Bank GEM databank

¹⁴The average depth of oil refining in Ukraine is estimated at about 65%.
away from these events, steel prices are likely to start picking up again, pressured by high raw material prices. In addition, Ukraine’s metallurgy is likely to benefit from a continuing strong rebound in construction. Growth moderation in machine-building to 13.6% yoy in April compared to a 27% yoy increase in IQ 2011 occurred on account of slower industrial growth in Russia and a high statistical base. On the upside, production of chemicals accelerated to 14% yoy in April 2011, taking advantage of world fertilizer prices moving upwards as well as lower natural gas prices.

Improvements in domestic demand driven branches were, however, insufficient to compensate for the weakness in export-oriented branches. As a result, industrial production growth decelerated to 5% yoy in April 2011, down from 9.7% yoy growth in 1Q 2011. Furthermore, the growth rates in cargo transportation and wholesale trade turnover, closely linked to industrial sector performance, eased to 8.7% yoy and 3.2% yoy respectively over January-April 2011. While many of the causes of industrial sector weakness may be temporary, we keep our real GDP growth forecast at 4.5% yoy in 2011 amid likely slower growth in the second quarter of the year and strong imports. In the meantime, Ukrainian officials expect economic growth to stay at more than 5% yoy in 2011 (the official forecast remains unchanged at 4.5% yoy). Furthermore, the growth is forecast to accelerate to 6.5% yoy in 2012 thanks to a favorable external environment, high investment activity thanks to improving access to bank credit and growing profitability, and the positive impact of hosting the Euro-2012 football championship. Given the high dependence of the Ukrainian economy on the external environment amid a world economy facing a number of challenges (high oil prices, overheating fears for China, Brazil and India, etc.) and the uneven progress with domestic economic reforms, the government forecast seems to be overly optimistic.

Fiscal Policy

Robust economic activity, a broader tax base (due to simplified taxation system restrictions), higher excise duties and royalty tax rates allowed the government to collect about UAH 90 billion ($11.3 billion) in revenues over January-April 2011, almost 21% higher than in the respective period last year. The period growth rate compares very favorably to annual budget revenue growth target of 11.4% yoy; however, it was a noticeable deceleration from the 28.5% yoy increase in 1Q 2011. Higher VAT refunds (about UAH 3.4 billion in April compared to a monthly average of UAH 3 billion over January-March), a reduction of excise taxes on gasoline products and the waning effect of a one-off increase in corporate tax proceeds in February due to a technical change in the tax administration were the primary reasons for the deceleration. Further moderation of budget revenue growth may be expected due to a corporate tax rate cut to 23% (from the previous 25%), the impact of which will be felt in 3Q 2011, enforcement of tax holidays for small business and government plans to re-introduce a simplified taxation system. In mid-May 2011, three bills amending the Tax Code (regarding the simplified taxation system) were registered in the parliament. Although the proposed system will be less generous than before (i.e., small business and private entrepreneurs will pay a single state social insurance contribution – 34.7% in addition to a ‘single system tax’, the types of activities eligible for the system will be narrower), its re-institution may contribute to a fiscal revenue growth slowdown in the second half of the year.

Despite likely slower growth in the second half of 2011, the annual target for budget revenues at UAH 281.5 billion looks realistic. However, the achievement of a broad fiscal deficit target looks very challenging as looming parliamentary elections (scheduled for October 2012) and declining ruling party popularity urged the government to postpone fiscal consolidation measures and increase social spending. Thus, the government deferred natural gas price increases to the population, and has delayed the approval of measures aimed at reducing Naftogaz imbalances and implementation of pension reform. In mid-May, the government approved a resolution envisaging larger wage increases for public sector employees. In the 2011 state budget law, an increase in the public wage bill was limited to compensate for the inflation rate, projected at 8.9% yoy at the end of the year. According to the new resolution, however, the

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8Russia is the major destination for Ukraine’s heavy machinery exports. In April 2011, Russian industrial production expanded by 4.5% yoy, well below the Bloomberg median consensus estimate of 5.4% yoy. Slowing industrial production signals weaker demand for capital goods, and thus for Ukrainian made machinery.

9Last year, machine-building was the fastest growing branch of industry, advancing by 34% yoy in April 2010.

10Since March 2011, natural gas for the chemical industry is imported at a price of $170 per m3 compared to a regular price of $295.6 per m3 for Ukraine in 2Q 2011.


12In February 2011, private enterprises paid their corporate profit taxes on profits earned during the entire 4Q of 2010, while in the previous years, February was the reporting period for profits received in December of the preceding year.

13If approved, the system will be enforced beginning July 1st, 2011.

14During February’s IMF staff visit to Ukraine, a more gradual schedule for natural gas tariff adjustment to the population was agreed – 20% in April and another 10% in June. However, the April’s increase was not implemented. So far, the Ukrainian authorities plan to decide on further natural gas adjustments in November.
first class tariff rate will be raised by a total of 12.6% from July to December 2011. As public sector wages are proportionately tied to the first class tariff rate, public sector wages are likely to increase at a faster pace. In addition, the resolution also foresees a number of wage premiums for health care workers and teachers, one-time cash aid benefits for young professionals, etc.

Hence, state budget expenditures, which grew by a relatively moderate 16.2% yoy in the first quarter of 2011, are likely to increase much faster than was initially planned (according to the budget law, expenditures were targeted to increase by only 4.4% yoy in nominal terms in 2011). During May 2011, the top Ukrainian officials announced that the consolidated budget (state and local budgets, including the official Pension fund deficit projected at 1.4% of GDP) may be balanced this year. Given the higher Naftogaz imbalances and Pension fund deficit, this may help keep the broad fiscal deficit at the targeted 3.5% of GDP in 2011. At the same time, projected slower fiscal revenue growth and recent government spending initiatives make the achievement of a balanced budget this year very unlikely. Due to higher expenditure growth (18.6% yoy in January-April compared to 16.2% yoy in 1Q 2011), the state budget balance reported a deficit of UAH 4 billion, 5.5% wider than in the corresponding period last year.

Despite the Ukrainian government’s commitment to meet the broad fiscal deficit target, the failure to comply with other performance criteria (pension reform, natural gas price hikes to households, etc.) put IMF program resumption at the beginning of July at risk. The suspension of the program, however, will not have a direct impact on Ukraine’s public finances in 2011 as the program does not foresee the use of IMF funds for budget purposes after 2010. However, with the program being off-track, fiscal discipline is likely to loosen, particularly taking into account the upcoming parliamentary elections. A more gradual fiscal consolidation and weaker incentives for implementing reforms would mean greater fiscal and debt sustainability risks in the medium term. Furthermore, the suspension of the IMF program will make the country much more exposed to external economic adversities (such as a disorderly default by Greece or adverse movements in commodity prices).

The Ukrainian authorities seem aware that, to address Ukraine’s vulnerability, the continuation of the IMF program needs to be ensured. At the end of May – beginning of June 2011, Ukraine has expedited the implementation of other IMF requirements. In particular, at the beginning of June, the revised pension reform bill was registered in the parliament. In addition, a strong signal was made that the bill will be approved at the beginning of July. This increases the chances the IMF program may be resumed in July/August.

**Monetary Policy**

Following an acceleration of consumer price inflation to 9.4% yoy in April, supply side pressures on consumer prices are likely to ease in May and the summer months. First, supply of food products, which account for more than 50% in the consumer basket, is expected to increase thanks to higher agricultural harvest this year. Already in May, prices of vegetables lost speed thanks to a growing amount of early vegetables. In addition, prices of dairy products may decline due to falling purchase prices on raw milk. Second, domestic prices will experience some relief from the side of international food and energy prices. According to FAO, April’s food price index was 2% below its peak in February 2011. Furthermore, world crude oil prices fell by about 7.5% in May compared to the previous month. Third, the government delayed natural gas hikes to households and reduced excise taxes on gasoline products for three months starting in April. Despite the above developments, due to low statistical base effect, fast growth in domestic demand and a temporary nature of some of the government measures to contain price growth (reduction of excise taxes), inflation is likely to remain high. Hence, we keep our year-end inflation forecast at about 12% yoy in 2011.

Flooded with excess liquidity thanks to robust growth of deposits (up by 29% yoy in April 2011), sizable repayments on domestic government securities and low domestic interest rates, commercial banks are cautiously resuming credit activity. Overall, the stock of bank loans grew by almost 8% yoy in April. While the growth was mainly achieved on account of higher lending to corporate enterprises (up by 15.2% yoy), consumer lending is also strengthening. The stock of consumer loans fell by 8% yoy in April, mainly due to the declining decline in forex-denominated loans. At the same time, 12-month cumulative growth of new loans to households stood at 7.1% in April 2011, according to NBU data. With bank credit activity gaining strength and higher wage growth,
domestic demand factors are likely to have a stronger impact on inflation developments in the second half of the year.

At the end of May, a major step towards greater exchange rate market flexibility was made. In particular, the NBU amendments to foreign currency regulation and control legislation came into force. The new resolution set up a framework for foreign currency forward and swaps transactions. Moreover, the banks were allowed to trade on both the sale and purchase sides of the interbank forex market. Furthermore, swap transactions are allowed on both domestic and international markets. Modernization of the methodology to calculate open foreign exchange position, which currently does not allow including loan loss provisions for loans issued in foreign currency, is next on the agenda. The above mentioned measures are not only an important step towards switching to a more flexible exchange rate regime, but also an essential part of foreign currency risk hedging mechanisms. Foreign currency market liberalization is expected to improve commercial banks risk and liquidity management, but in the short-term may lead to higher exchange rate volatility given high commercial bank liquidity.

International Trade and Capital

Following strong demand and favorable price developments for Ukraine’s traditional export commodities in 1Q 2011, export growth slightly weakened but remained at a solid 32% yoy in April. Slower export growth may be explained by moderation of world steel price growth, Russia’s weaker demand for Ukraine’s machinery as industrial growth in Russia lost momentum during March-April, and an increasing statistical base effect. At the same time, the growth of imports also fell from an impressive 60% yoy in 1Q 2011 to 37% yoy in April. The deceleration came primarily as a result of lower natural gas imports as Naftogaz virtually completed the purchase of natural gas for delivery to RosUkrEnergo in 1Q 2011 to settle the Stockholm arbitration court ruling. In addition, moderation of Ukraine’s industrial production growth during March-April also contributed to moderation of import growth. At the same time, due to stronger consumption and strengthening investment demand, the growth of imports exceeded exports. In particular, the growth of machinery equipment and transport vehicles remained virtually unchanged at about 56.5% yoy in April.

Thanks to weaker imports, Ukraine’s trade deficit in goods narrowed to $0.7 billion in April. However, the cumulative January-April trade deficit was 2.3 times higher than in the corresponding period of last year. Correspondingly, despite some improvement in the current account balance in April, cumulative deficit stood at $1.6 billion, contrasting to a small surplus in January-April 2010. Though the prospects for Ukraine’s exports are favorable, elevated energy prices and buoyant domestic consumption (thanks to the government’s recent upward revision of social spending) will continue to fuel imports. Also taking into account real Hryvnia appreciation (as domestic inflation notably exceeds inflation rates in its main trading partner countries while the nominal exchange rate is kept virtually stable), Ukraine’s current account deficit is projected to widen to about 3% of GDP this year.

As anticipated, Ukraine’s capital and financial account turned into a large surplus of $1.3 billion in April thanks to the privatization of Ukrtelecom and sizable external borrowings by corporate enterprises. In contrast to the corporate sector, repayments in the banking sector notably surpassed new debt inflows. Successful BoP developments in the first half of 2011 were to a large extent attributed to faster-than-projected economic growth in the country, government progress in reducing the broad fiscal deficit from about 9% of GDP in 2009 to 6.5% of GDP in 2010 and commitment to continue with the IMF program despite February’s delay in disbursement. Though the country may manage its financing needs this year even without the IMF program if external environment remains favorable, its vulnerabilities to adverse external shocks will notably increase. In addition, recently external conditions became more challenging for Ukraine amid a pause in world steel price growth and Greece financial woes, which may jeopardize the recovery in the Eurozone and thus world economy as a whole. Hence, IMF program remains essential to increase resilience of the Ukrainian economy to external shocks.