Executive Summary

Cooling foreign demand, a lower grain harvest and falling construction works added to the deceleration of economic activity in Ukraine in 2012. In particular, in January-October, industrial production lost 1.5% yoy versus the same period a year ago as output in metallurgy declined by nearly 5% yoy. As a result, following two strong years of output recovery, factory activity is likely to experience a slight decline in 2012 as manufacturing is still struggling to rebound to its pre-crisis levels.

Essentially, a challenging global economic outlook is bringing down prices of chemicals and industrial metals – staple export commodities for Ukraine. The persistence of economic weakness in the Eurozone and Turkey paints a less optimistic picture for Ukrainian steelmakers. Meanwhile, Russia appears to be increasingly likely to treat Ukraine in a less friendly manner as the Ukrainian government wavers between its foreign trade policy options. All of this points to rather fragile foreign demand in 2013, which will limit the upside potential for Ukrainian industry and exports.

On the demand side of GDP, consumer spending, buoyed by growing wages, low inflation and looser fiscal policy, has been remarkably resilient. In 2012, retail sales are likely to increase on par with last year’s brisk rebound. After all, in January-October, inflation adjusted wages were up by nearly 15% both due to slower growth of consumer prices as well as faster increasing salaries in the public sector. Strong consumer spending is supporting service-providing sectors of the economy as well – business activity in the non-financial services industry was up by nearly 10% yoy. A similar uptick in consumer spending may be harder to sustain in 2013 as fiscal policy tightens. Thus, private consumption is likely to contribute less to economic growth in 2013. Still, the slower growth of domestic consumption has a silver lining – it will curb consumers’ demand for imports, reducing the external vulnerabilities of Ukraine.

Among the factors affecting consumer demand, the possibility of tighter budget policy looms large in 2013. After all, in 2012, as tax proceeds continued to slow, the growth of public expenditures quickened in the second half of 2012 and eventually surpassed the pace at which the government collects revenues. As a result, by the end of October, the state budget deficit, excluding Naftogaz deficit, widened to about 2.3% of GDP versus 1% a year ago. Above all, the growth of budget outlays was driven by welfare spending, which jumped by nearly 28% yoy or twice as fast as a year ago. And since spending patterns were amplified by the election cycle in 2012, budget expenditures may grow slower in 2013. In addition, fiscal consolidation measures, mostly delayed in 2012, look set to acquire a fresh urgency, as the government will try to secure IMF financing and regain the confidence of foreign creditors. Yet, to address the structural component of the budget deficit, it is necessary to reduce energy subsidies and introduce deeper reforms to social security in Ukraine. This means that next year, fiscal policy will remain neutral at best and may even create a modest drag on economic growth if tax revenues continue to disappoint.

Thanks to falling prices of foods, consumer prices remained mostly stable in 2012. In fact, in November, the consumer price index was even 0.2% yoy lower than a year ago due to a 3% yoy drop in food prices. In addition, many consumer goods were somewhat cheaper than a year ago, while prices of major services registered only trivial single-digit growth. As a result, core inflation, which ignores more volatile price changes of fuels and unprocessed foods and excludes administratively set service tariffs, continued to decelerate in November, posting a modest annual gain of only 0.9% yoy. This means that inflationary pressures stay relatively well contained. Indeed, considering the long period of healing awaiting Ukrainian banks, monetary sources of inflation are unlikely to unravel in the near future.

In 2012, Ukrainian exports barely grew as foreign demand visibly cooled due to slowing global economic activity. During the first ten months of 2012, exports inched up by 2.8% yoy as overseas shipments of nonferrous metals (23% of all exports) declined by nearly 15% yoy. Imports are showing signs of weakness as well – in January-October, imports grew by 4.4% yoy; however, they still increased faster than exports. Thus, the trade in goods deficit continued to widen and stood at $12.8 billion at the end of October or up from $11.4 billion a year ago. As a result, the current account deficit has been expanding at a faster pace in 2012. Preliminary estimates of the National Bank of Ukraine place the current account deficit at $11.1 billion in the first ten months of 2012, which is $3.6 billion higher than a year ago and already exceeds the current account gap for all of 2011 by nearly $1 billion.
Economic Growth

Business activity continued to decelerate in Ukraine in weak foreign demand, lower grain harvest and falling construction works offset gains in trade and the service-providing sectors of the economy. In particular, during the first eleven months of 2012, industrial output decreased by 1.5% yoy versus the same period a year ago. Although output in mining and utilities saw modest gains of about 2.5% yoy, manufacturing shrank by 4.5% yoy as fuel processing lost over a quarter of its output, while production in metallurgy decreased by nearly 5% yoy. As a result, following two strong years of output recovery, factory activity is likely to experience a slight decline this year as manufacturing still struggles to rebound to its pre-crisis levels.

As prices of chemicals and industrial metals (staple export commodities of Ukraine) remain depressed, local exporters have to navigate an increasingly tougher external environment. Indeed, due to economic weakness in the Eurozone and Turkey, which is a big buyer of Ukrainian ferrous metals, metallurgy may be on course for a rather listless performance next year. According to the IMF, the Euro area will remain depressed, local exporters have to navigate an increasingly tougher external environment. Indeed, due to economic weakness in the Eurozone and Turkey, which is a big buyer of Ukrainian ferrous metals, metallurgy may be on course for a rather listless performance next year. According to the IMF, the Euro area will barely grow next year, while Turkey will decelerate to 3% and 4% yoy in 2012 and 2013 from about 9% yoy in 2011 and 2010. The economies of Italy and Spain, two key European trade partners of Ukraine, look certain to enter a new recession in 2013. Meanwhile, Russia, which is a destination for over a quarter of all Ukrainian exports, appears to be growing increasingly impatient as Ukraine wavers between its foreign trade policy options. Thus, there is a risk that trade relations between the two countries may become less friendly, which will hurt Ukrainian exporters particularly hard. All of this points to external shocks as a big source of next year economic risks in Ukraine. True, the global economy has been recently showing signs of life as China’s industrial production is growing at a faster pace, while the labor and housing markets in the U.S. are slowly improving. But as fiscal consolidation in the Euro zone is gathering speed and uncertainties over America’s budget policy persist, foreign demand is likely to remain rather fragile, which will limit the upside potential for Ukrainian industry and exports.

On the upside, consumer spending, which now represents over two thirds of the country’s economic activity, has been remarkably resilient. In fact, this year retail sales are likely to increase on par with last year’s brisk rebound. Several factors contributed to this trend. First, in January-October, inflation adjusted wages were up by nearly 15% both due to the slower growth of consumer prices as well as faster increasing salaries in the public sector and, in particular, in education and healthcare. A slower pace of consumer deleveraging and higher government spending on welfare programs and social assistance are adding to consumers’ buying power as well. Thus, a big question is whether a similar uptick in consumer spending can be sustained next year. Indeed, as local economic activity slows and the government budget tightens, double-digit wage growth may disappear. Perhaps muted inflation
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pressures and relatively stable food prices (spending on foods still accounts for over 40% of all consumer expenditure) may help offset a less rapid increase in nominal incomes. However, consumers may face fewer options to smooth consumption with borrowing as foreign (mostly European) banks continue to retreat from Ukraine. On the balance, it is reasonable to expect that next year private consumption may struggle to make up for the weakness of exports. Still, slower growth of domestic consumption may have a silver lining as it will curb consumers' demand for imports.

Finally, domestic investment demand appears to be tapering off. Indeed, following a healthy rebound in the first two quarters of 2012, gross fixed capital investments dropped by 3% yoy in the third quarter of 2012. In particular, capital spending across manufacturing sectors was mixed as total investments in manufacturing dropped by 2.1% versus January-September 2011. Still, over the first three quarters of this year, fixed capital outlays were up 17% yoy, partly thanks to 39.2% yoy growth of residential housing investments (which constitute nearly one seventh of all capital spending). On that note, consumers appear to be spending more on housing – the share of funds spent by Ukrainians on investments in residential properties in total capital spending increased to 8.1% from just 5% the year before. Having said that, the construction industry continued to shrink as the volume of construction works declined by 12.1% yoy in January-November 2011. This can be attributed to falling spending on large infrastructure projects (for instance, roads and airports) as last year’s spurge on public investment prior to the Euro-2012 football cup continues to abate. However, a 14% yoy drop in construction of buildings and dwellings (or nearly half of total construction works) implies that the homebuilding industry is on the path of a rather protracted and sluggish recovery.

**Fiscal Policy**

In 2012, the growth of budget spending and revenues followed a markedly divergent path. In particular, as tax proceeds continued to slow, the growth of public expenditure quickened in the second half of 2012 and eventually surpassed the pace at which the government collects revenues. Thus, in January-October, general budget revenues were up by 11% yoy while budget spending saw a gain of 17% yoy. Contrary to this, last year budget revenues grew by 26.7% yoy or much faster compared to a 10.3% yoy increase in budget expenditures. Not surprisingly, the state budget deficit (excluding Naftogaz deficit, which may exceed 2% of GDP in 2012) widened to UAH 33.2 billion (compared to UAH 12.4 billion or about 1% of GDP during the same ten months of 2011) or about 2.3% of the projected full-year GDP.

On the revenues side, tax collection continued to lose speed as economic activity weakened. In particular, proceeds from the personal income tax grew by only 14% yoy versus 19.2% yoy in January-October 2011. Revenues from the corporate income tax (about 12% of the total budget inflows) edged up by less than 5% yoy compared to 42% yoy a year ago. This may imply that business conditions noticeable deteriorated in 2012. More importantly, own funds are a source of over 60% of the capital outlays in Ukraine. Thus, as after-tax corporate profits get squeezed, investment spending is likely to moderate. Lastly, although collection of taxes on imports retained its double-digit growth rates, proceeds from the VAT (over 30% of all budget revenues) moved up by only 6% yoy – down from a 63.2% yoy increase in the first ten months of 2011. And this is an obvious sign of the ongoing deceleration of broader economic activity in Ukraine.
Meanwhile, budget spending grew by 17% yoy compared to a more modest increase of about 10% yoy a year ago. Above all, this year, the growth of budget outlays was driven by welfare spending (mostly on public-funded pensions as well as other types of social assistance), which jumped by nearly 28% yoy or twice as fast as a year ago. Spending on education and healthcare accelerated as well, increasing by 20% yoy and 25% yoy, respectively. True, this year’s spending patterns were amplified by the election cycle; thus, budget expenditures may grow slower in 2013. Indeed, since fiscal consolidation measures were for the most part delayed in 2012, the government will face growing pressures to tighten the budget both to secure IMF financing and regain the confidence of foreign creditors. To address the structural component of the budget deficit it may become necessary to reduce energy subsidies and introduce deeper reforms to social security in Ukraine, including the state-financed pension system. This means that next year, fiscal policy will remain neutral at best and may even create a drag on economic growth if tax revenues continue to disappoint.

Monetary Policy

Thanks to falling prices of foods (the biggest component in the consumer price basket), consumer prices remained mostly stable in Ukraine in 2012. In particular, in November, prices paid by consumers for goods and services stood virtually unchanged (down by 0.2% yoy) versus a year ago, mostly due to a 3% yoy drop in food prices. In addition, prices of many consumer goods – from apparel and footwear to consumer electronics – were lower than a year ago, which helps partly explain this year’s boom in retail sales. Meanwhile, prices of many services (for example, education, healthcare, transportation, telecommunications and utilities) registered only trivial single-digit growth rates. However, the impact of these modest gains on the overall price level was muted by the relatively low shares of these services in aggregate consumer spending. For instance, education prices increased by 4.4% yoy in November, yet their weight in the CPI was just 1.7%. Thus, higher costs of education contributed less than one thirteenth of a percentage point to the inflation figure. As a result, core (or base) inflation, which ignores more volatile price changes of fuels and unprocessed foods and excludes administratively set service tariffs (for instance, in utilities and housing) continued to decelerate in November, posting a modest annual gain of only 0.9% yoy. And this means that inflationary pressures stay relatively well contained.

After all, monetary sources of inflation are still weak. In fact, lending by banks has been losing momentum since the start of 2012. Although, due to a recent uptick in corporate borrowing, the stock of credit issued by banks grew slightly faster in November – up by 2.8% yoy – retail loans (credit issued to households) continued to contract and were 6% lower than at the start of this year. This is mostly due to a nearly 17% ytd drop in mortgages outstanding as households continued to repay their loans and shied away from new borrowing. In addition, this trend may reflect tightening access to loans as lenders still maintain relatively conservative lending standards by cutting exposure to riskier retail customers. Encouragingly, the banking industry returned to profitability in 2012, earning UAH 4.4 billion in after-tax profits during the first eleven months of this year compared to a loss of UAH 4.8 billion a year ago. Still, banks’ returns on equity and assets (ROA and ROE) remain well below their pre-crisis levels, which reflects the growing share of nonperforming loans and points to a long period of healing awaiting Ukrainian banks in the future.

International Trade and Capital

During the first ten months of 2012, exports of grains more than doubled (increasing by 112% yoy), which testifies to the great export potential for Ukraine’s agriculture. Still, Ukrainian exports barely grew as foreign demand for metals visibly cooled due to slowing global economic activity. Thus, in January-October 2012, exports inched up by 2.8% yoy – a striking deceleration from 35.8% yoy a year ago. Although exports have recently registered a modest uptick due to increasing overseas shipments of foods and agro commodities and machinery, exports of nonferrous metals remained on a
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downtrend. Meanwhile, imports are showing signs of weakness as well – in January-October, imports grew by 4.4% yoy versus 40.1% yoy during the same ten months of 2011. Still, as imports have been recovering at a faster pace compared to exports, the trade in goods deficit continued to widen and stood at $12.8 billion at the end of October or up from $11.4 billion a year ago.

In fact, with the exception of grain exports, all of Ukraine’s major exports posted a deceleration in the first ten months of 2012. Most importantly, exports of nonferrous metals (23% of all exports) declined by nearly 15% yoy. Exports of chemical products dropped by about 2% yoy (over 7% of all exports) compared to a nearly 60% yoy gain a year ago as exports of Ukrainian fertilizers barely grew this year. Exports of mineral products (11% of all exports) were 23% yoy less than a year ago on sizable drops of exports of mineral fuels and coal. On the upside, exports of transportation equipment (about 9% of all exports) continued to expand at a respectable rate of over 25% yoy (although this was twice as slow as year ago) mostly thanks to booming exports of the local aerospace industry.

These export trends do reflect the geographical composition of Ukrainian exports and, in particular, the excessive exposure to stagnating Eurozone economies and slowing business activity in Turkey. Indeed, in January-October, exports to the European Union (about a quarter of all exports) were 8% yoy lower than a year ago, primarily due to a 25% yoy drop in exports to Italy (over 3% of all exports) as well as flat exports to Poland (nearly 4% of all exports). Exports to Turkey (over 5% of the total) failed to grow as well, which may help explain this year’s poor performance of nonferrous metallurgy. Meanwhile, exports to CIS countries (37% of the total) edged down by 1.4% yoy on a 10% yoy drop of exports to Russia (nearly 27% of the total). Still, increasing overseas shipments to Kazakhstan and Belarus (the second and third biggest CIS export markets for Ukraine) helped offset declining Russian demand for Ukrainian goods. Lastly, Ukraine has to put up with a subsiding demand for its products from big emerging countries as their economies continue to moderate. Indeed, exports to India (over 3% of the total) grew much slower than a year ago, while exports to China (2.7% of the total) dropped by over 10% yoy during the first ten months of 2012. Slowing recovery in the Americas (which account for about 4% of all Ukrainian exports), most importantly in the United States and Brazil, may impede the geographical diversification of Ukrainian exports from Europe to more promising destinations – for instance, emerging economic powerhouses in Latin America, such as Mexico and Brazil.

Due to a much slower growth of exports, the current account deficit has been expanding faster this year. Preliminary estimates of the National Bank of Ukraine place the current account deficit at $11.1 billion in the first ten months of 2012, which is $3.6 billion higher than a year ago and already exceeds the current account gap for all of 2011 by nearly $1 billion. Meanwhile, foreign direct investments have been flowing into the country at a slower pace than in 2011, as heightened global and domestic economic uncertainties were a strong deterrent to private investors. And this amplifies the external financing needs of Ukraine, which may put at risk the already fragile stability of the exchange rate and may elevate the vulnerability of the economy to external shocks.