

October 2012

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- According to preliminary estimates, real GDP contracted by 1.3% yoy in 3Q 2012.
- Industrial production fell by 4.7% yoy in August and 7% yoy in September amid further slowdown in external demand and weakening domestic factors.
- Slower budget revenue growth and faster growth in expenditures resulted in sharp state budget deficit widening in January-September.
- Due to parliamentary elections, the government not only delayed fiscal consolidation measures but also increased the official budget deficit target to 2.1% of GDP from the previous 1.7% of GDP.
- Without fiscal adjustment measures, total public sector deficit (including Naftogaz and Pension Fund) may reach 5% of GDP in 2012.
- On a positive note, the 2013 draft budget law will likely be revised in compliance with IMF requirements as the 2013 budget was at the core of talks with the technical IMF mission that visited Ukraine at the end of October.
- Ukraine reported zero annual inflation in September. Year-end price growth will likely not exceed 4% yoy, but some acceleration is expected next year.
- Despite further growth in agricultural exports, Ukraine's external balances continued to worsen in August-September with nine month current account gap amounting to \$9.2 billion.
- Deteriorating foreign trade balance, high external financing needs and strong population demand for foreign currency kept generating Hryvnia depreciation pressures.
- The National Bank of Ukraine used a mix of monetary and administrative measures to maintain the Hryvnia peg to the US Dollar, but may allow greater Hryvnia flexibility after the parliamentary elections.

Executive Summary

The slowdown in the Ukrainian economy intensified in August-September, affected by further weakening of the external environment and softening domestic demand. Ukraine's industrial output fell by 4.7% yoy in August and 7% yoy in September. Slipping global demand for steel and iron ore weighed on the steel and mining industries. In addition, production of machinery equipment and transport vehicles suffered from increased trade tensions with Russia, the largest consumer of Ukraine's machinery products. In particular, output production in the machine-building industry fell by almost 17% yoy on average over August-September as the Ukrainian government failed to negotiate an exemption from the utilization fee introduced by Russia on imported cars.

Domestic demand has also been cooling. A steep decline in the construction sector (by about 9% yoy over January-September 2012) signaled the subdued investment activity. Due to strained public finances, an ongoing credit squeeze and restricted access to foreign financing, the current level of investment spending cannot fill the gap left after the completion of large infrastructure projects related to the Euro 2012 football championship. Moreover, a deceleration in retail sales growth to 16% yoy over January-September indicates that private consumption has started to ease. While a deceleration in real wage growth to 11.7% yoy in September contributed to softening demand, consumer spending was likely affected by growing political and economic uncertainties. Due to weaker external and internal growth factors, the Ukrainian economy is forecast to increase by about 1% yoy in 2012.

Worsening real sector performance adversely affected budget revenues, which rose by a nominal 8.7% yoy over the first nine months of 2012. At the same time, expenditures kept gaining momentum on higher social spending ahead of parliamentary elections, causing sharp state budget deficit

widening. Although slower economic growth and lower inflation, as well as the practice of collecting tax payments in advance, leaves little room for revenue improvement, the government delayed the fiscal adjustment measures until after the parliamentary elections. On the contrary, during the second half of September and October, the state budget law was amended several times, increasing the state budget deficit target by almost 24% to 2.1% of GDP. Given these developments, we have revised our full-year public sector deficit (including Naftogaz and the Pension Fund) to 5% of GDP in 2012, but believe the necessary adjustments will be made for next year's budget. The arrival of the technical IMF mission to Ukraine at the end of October to discuss the 2013 budget and the Ukrainian government's reform measures increases the chances that the IMF program may be resumed at the end of this year/the beginning of 2013.

Ukraine's inflation remains at a decade low level. In September, consumer prices stayed flat compared to a year ago thanks to continuing reduction in the cost of foodstuffs and beverages, downward adjustment in public transportation tariffs and virtually unchanged utility tariffs. As a result, annual inflation may stay below 4% yoy at the end of 2012. Despite eased inflationary pressures, monetary policy remains tight. The National Bank of Ukraine continues to use a mix of its policy measures (banking sector liquidity regulation, forex interventions, and administrative restrictions) to suppress Hryvnia foreign exchange fluctuations. A relative stability of the exchange rate, however, was achieved at the cost of subdued bank lending activity. Indeed, the stock of bank loans rose by only 1.2% from January to September this year.

A good agricultural harvest, large grain stockpiles ahead of a new marketing year and elevated world grain prices supported Ukraine's exports of agricultural products, which expanded by about 50% yoy on average over August-September this

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year. This improvement, however, could not compensate for weaker exports of other key commodity groups (metallurgy, machinery, minerals). As a result, exports slowed to 1.1% yoy in August and fell by about 3% yoy in September. While imports also eased, Ukraine's current account stood high at about \$1.4 billion in August and September. The nine month gap amounted to \$9.2 billion and is forecast to reach 6.5% of GDP this year. Growing external imbalances, high external debt financing needs amid turbulent international financial markets and strong population demand for foreign currency generate depreciation pressures. Moderate Hryvnia depreciation may be allowed after parliamentary elections to prevent depletion of gross international reserves beyond three months of imports and improve competitiveness.

	2007	2008	2009	2010	2011	2012 ^f
GDP growth. % yoy	7.9	2.3	-14.8	4.1	5.2	1.0
GDP per capita. \$	3 069	3 891	2 545	2 974	3 608	4 000
Industrial production. % yoy	7.6	-5.2	-21.9	11.2	7.6	-2.0
Retail sales. % yoy	28.9	18.1	-16.6	9.8	14.7	-
Budget deficit. % GDP*	-1.7	-2.0	-8.9	-7.0	-4.4	-5.0
Government external debt. % GDP	8.7	9.3	20.5	23.8	21.0	19.0
Inflation. eop	16.6	22.3	12.3	9.1	4.6	4.0
Gross international reserves. \$ billion	32.5	31.5	26.5	34.5	31.8	26.0
Current account balance. % GDP	-3.7	-7.0	-1.5	-1.9	-5.5	-6.5
Gross external debt. % GDP	56.1	56.5	88.2	86.0	76.6	67.0

*Including implicit pension fund deficit in 2007-2009, and including Naftogaz and pension fund deficits since 2009 (not including bank recapitalization expenditures and VAT refund bonds). Revised data for 2009-2010.

Source: State Statistics Committee of Ukraine, NBU, Ministry of Finance of Ukraine, 2011 Budget Law, The Bleyzer Foundation

Economic Growth

As the global slowdown intensified and domestic demand softened, the Ukrainian economy contracted by 1.3% yoy in 3Q 2012, for the first time since 2009, according to early State Statistics Committee of Ukraine estimates. Sharp declines in economic activities were reported for August and September this year. Weak external demand and trade tensions with Russia hampered exports and export-related sectors. In addition, tight credit conditions, deterioration in consumer and producer confidence amid rising economic and political uncertainties, and lower public investment spending following the finalization of major infrastructure projects and a more difficult fiscal situation weighed on domestic demand and investments in particular. Weakening investment activity led to a marked decline in the construction sector, where real value of works fell by 9.1% yoy over the first nine months of the year.

Moreover, real wage growth, the driver of private consumption in 1H 2012, continued to lose momentum over these two months. While consumer inflation remains at a decade low, the deceleration mainly reflects weak performance of real sector activities. Real wage growth moderated to 11.7% yoy in September, pointing to softening consumer demand.

Due to the combination of weaker foreign and domestic demand, industrial production output fell by 4.7% yoy in August and 7% yoy in September. Machine-building was particularly hit following Russia's introduction of a recycling fee on imported transport vehicles. As Russia is the principal market for Ukraine's exports of transport vehicles and the Ukrainian government failed to negotiate an exemption from the fee, the output decline in the industry deepened to 13.7% yoy and about 20% yoy in August and September respectively. Affected by slipping global demand, world commodity prices continued to decrease, weighing on Ukraine's production of steel and chemical products. Output production in metallurgy was 9.4% yoy lower in September, while the growth in the chemical industry slowed to 0.8% yoy that month compared to 10.3% yoy growth a month before. A steep decline in the construction sector and weak steel industry performance exerted a toll on Ukraine's production of construction materials and extraction of non-energy minerals, whose output declined by about 8% yoy and 2% yoy respectively in September. A continuing downturn in domestic oil refining (where the output drop amounted to about 50% yoy in August-September) and an almost 5% yoy decline in food processing in September contributed to the industrial sector's downturn.

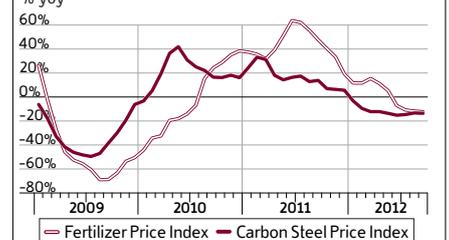
By the end of October, the country had collected 41.2 million tons of cereal and legumes; the total grain harvest is estimated at 46 million tons, according to the Ministry of Agrarian Policy and Food. Although this year's crop will be higher than the five-year average, it will be 19% lower compared to a record high 56.7 million tons reaped last year. Given the very high base effect in crop production, the sector's total output production reported a

Real Sector Performance of Ukraine

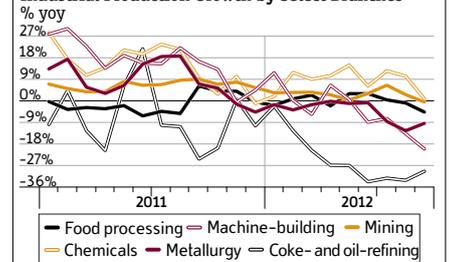
	2012		2011	2010	2009
	9m	8m			
Agriculture	-4.6	-4.5	17.5	-1.5	-1.8
Industrial output	-1.2	-0.4	7.6	11.2	-21.9
Construction works	-9.1	-8.0	11.1	-5.4	-48.2
Domestic trade turnover					
Wholesale trade	-2.4	-1.7	0.6	0.4	-19.3
Retail trade	16.0	16.0	14.7	9.8	-17.4
Restaurants	7.8	8.0	11.0	3.5	-15.6
Transportation turnover					
Cargo	-7.0	-7.2	5.7	6.4	-22.5
Passenger	-0.9	-0.7	3.3	-0.2	-11.5
Services, non-financial	10.7	11.2	18.6	2.9	-16.8

Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

World Steel and Fertilizer Price Indices



Industrial Production Growth by Select Branches



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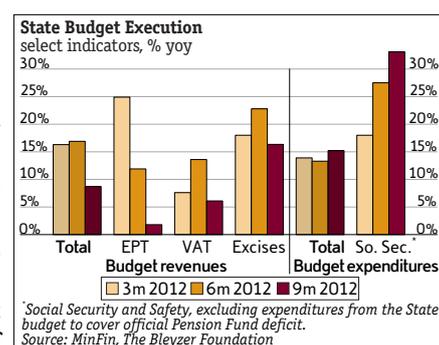
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decline of 4.6% yoy for January-September. At the same time, as the harvest campaign neared completion in Ukraine, the decline in agriculture lost speed in September.

Despite a lower harvest, Ukraine's grain stockpiles stood high before the new marketing season due to a record high 2011 crop and export restrictions. Taking advantage of elevated world grain prices and anticipating the possibility that Ukrainian authorities may restrict grain exports, traders notably increased grain sales abroad. This supported Ukraine's cargo transportation sector but could not compensate for the decline in cargo turnover related to a weaker industrial sector and non-agro exports. As a result, although cargo turnover reported a slight improvement in September, it was 7% lower than in January-September last year. Due to weaker external and internal growth factors, the Ukrainian economy is forecast to increase by about 1% yoy in 2012.

Fiscal Policy

Worsening real sector performance and lower than projected inflation resulted in a sharp deceleration in budget revenue growth over August-September. In nominal terms, collections to the state budget were only 8.7% yoy higher over January-September. Moreover, excluding the impact of higher NBU profit transfers to the budget, revenue growth amounted to a modest 5.6% yoy for the period. The main reason for the deceleration was poor corporate profit tax (EPT) receipts. Being the second largest source of budget revenues (about 17% of total), they rose by a nominal 1.8% yoy over the first nine months of the year. While economic slowdown in the third quarter had a significant impact, the revenue growth from this tax was also affected by a tax rate reduction by 2 percentage points since the beginning of this year, as well as the widespread practice of advance collections of tax payments. At the same time, the slowdown in VAT and excise proceeds may be an additional signal of weakening domestic demand.



At the same time, expenditures kept gaining momentum on higher social spending ahead of parliamentary elections. In particular, budget spending on social security and safety, excluding expenditures to cover the Pension Fund deficit, accelerated to a nominal 33% yoy over January-September. Total expenditures grew at a more moderate pace of 15.2% yoy for the period. However, this growth was achieved thanks to lower public investments and under-execution of 'non-social' programs. As revenue growth weakened and expenditures sped up, Ukraine's state budget deficit widened to UAH 24.4 billion (about \$3 billion) for January-September. The deficit was almost three times higher than in the respective period last year and represented about 90% of the annual target for 2012¹.

Due to lower than planned economic growth and inflation for 2012, the full-year budget revenue target is likely to be under-fulfilled. Given little room for raising additional revenues without a spending adjustment, the deficit will be driven higher than projected. Due to parliamentary elections, however, the revision of the budget policy was delayed. On the contrary, during the second half of September and October, the state budget law was several times amended. As a result, budget revenue and expenditure plans for 2012 were raised by 0.9% and 2.3% respectively, while the deficit target was increased by about 24% to UAH 31.1 billion (\$3.9 billion or 2.1% of GDP). These amendments as well as the accumulated financing to cover short-term fiscal need² raise uncertainty that the necessary fiscal adjustment will be made after the elections. As a result, we have worsened our full-year public sector deficit (including Naftogaz and Pension Fund) forecast to about 5% of GDP.

	Plan as of mid-Sep.	Revised plan	% change
Revenues, UAH billion	370.8	374.0	0.9
Expenditures ^{**} , UAH billion	395.9	405.1	2.3
Balance, UAH billion	-25.1	-31.1	23.8
Balance, % of GDP	-1.7%	-2.1%	

*Plan after September-October amendments.
Including net credit from the budget.
Source: MinFin, 2012 State Budget Law, The Bleyzer Foundation*

A pause in the reduction of public sector deficit in 2012 will likely mean a more painful fiscal adjustment next year, particularly taking into account the government intension to resume cooperation with the IMF. In particular, the Ministry of Economy has already revised its macroeconomic forecast downwards for 2013, which means the revenue target will also be lowered for next year. Real GDP is now forecast at 3.5% yoy for 2013 compared to the previous 4.5% yoy. Despite the pick-up in economic activity in 2013, the revenue growth alone may be insufficient to restore Ukraine's fiscal position and sustain its public debt as fiscal needs will also increase. In particular, Ukrainian authorities (government and NBU) have to repay about \$6 billion to the IMF alone next year compared to about \$3 billion this year. To secure financial assistance from the IMF, the government will have to show progress in fiscal consolidation. For this, measures to address Naftogaz and Pension Fund imbalances should be presented, but are still lacking. On a positive note, a technical mission of the IMF arrived in Kyiv at the end of October to discuss further cooperation with next year's budget parameters being at the core of negotiations. This increases the chances the program may be unfrozen at the end of 2012/ beginning of 2013.

¹The annual target as of the end of September 2012.

²Taking advantage of a temporary improvement on international financial markets, in September the Ukrainian authorities attracted \$0.6 billion thanks to additional placement of sovereign Eurobonds issued in July this year. In addition, the government partially rolled over a \$2 billion VTB loan and received UAH 5.3 billion (\$0.7 billion) of privatization receipts.

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Monetary Policy

Ukraine continues to enjoy low inflation. In September, consumer prices stayed flat compared to a year ago. Continuing reduction in the cost of foodstuffs and beverages, downward adjustment in public transportation tariffs and virtually unchanged utility tariffs compensated for resumed growth in domestic fuel prices and a seasonal increase in the cost of education services.

To a notable extent, however, almost decade low consumer price growth was achieved thanks to the Ukrainian authorities' administrative control over price developments on socially important goods and services (bread, cereals, sugar, utility costs and transportation tariffs, etc.). Contained ahead of parliamentary elections, price growth may accelerate through the end of the year and next year as the government may allow at least partial tariff adjustments after the elections. In particular, the government may now be more prepared to raise heavily subsidized natural gas and heating tariffs to the population. Low energy tariffs for the population amid high costs of energy imports exert a severe drag on public finances (both state and Naftogaz budgets). Hence, their adjustment remains one of the principal requirements of the IMF to resume its cooperation with Ukraine.

Additional inflationary pressures may be the result of a weaker agricultural harvest this year and likely Hryvnia depreciation pass-through to import prices. However, given the first nine month price growth, annual inflation may not exceed 4% at the end of 2012 but is likely to speed up to about 7-8% yoy next year.

Ukraine's deteriorating foreign trade balance, high external debt financing needs and strong population demand for foreign currency amid increased political and economic uncertainties pressured the Hryvnia exchange rate during September-October. To suppress Hryvnia foreign exchange fluctuations, the National Bank of Ukraine continued to use a complex mix of foreign currency interventions on the interbank market, banking sector liquidity regulations and administrative restrictions to curb population demand for foreign exchange. These measures allowed the NBU to keep the Hryvnia at about 8.1 per USD through the end of October but caused a depletion of gross international reserves and a credit crunch.

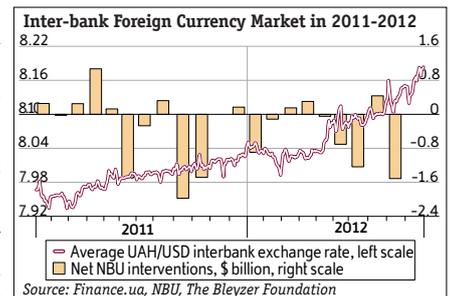
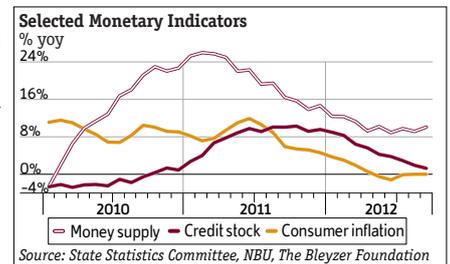
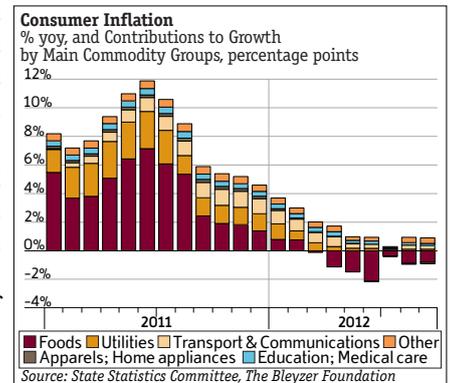
Thus, gross international reserves fell by 2.5% mom to \$29.2 billion as of the end of September and continued to decline in October. Given Ukraine's challenging external balance outlook for the rest of the year, high depreciation expectations and the reserves approaching the safety threshold of three months of imports, greater exchange rate flexibility may be expected after the parliamentary elections. Moving from a hard currency peg to greater exchange rate flexibility is also a repeated IMF recommendation for the Ukrainian government to cushion against adverse shocks. At the same time, with the resumption of IMF financing, depreciation is expected to be moderate.

The sterilizing effect of the NBU interventions on the interbank forex market (amounting to \$1.5 billion on September) on monetary aggregates and a tight liquidity stance continued to drag on commercial banks' lending activity and thus economic growth. Indeed, bank credit stock was only 1.3% yoy higher as of the end of September 2012. Moreover, excluding loans issued to state-run enterprises, credit growth stood at only 0.7% yoy. To revive credit growth, and thus economic activity, the central bank may be prepared to ease banking sector liquidity after the parliamentary elections. However, given current economic uncertainties and Hryvnia depreciation expectations, improved liquidity may cause higher Hryvnia exchange rate fluctuations.

International Trade and Capital

As anticipated, following some improvement in July, Ukraine's external balance worsened in August-September. Thus, Russia's new import restrictions to protect its domestic machinery industry after accession to the WTO have severely hit Ukraine's exports of transport vehicles. Overseas shipments of this commodity group decelerated to 12% yoy in August and dropped by 3% yoy in September. Weak external demand and declining world steel and fertilizer prices hamper metallurgical and chemical exports, which fell by 11.6% yoy and 13.3% yoy over August-September respectively. On a positive note, thanks to a good agricultural harvest, large grain stockpiles ahead of a new marketing year and elevated world grain prices, Ukraine's exports of agricultural products expanded by almost 50% yoy on the period. But they could not compensate for weaker exports of other key commodity groups. As a result, total exports of goods slowed to 1.1% yoy in August and fell by 3% yoy in September.

Imports also decelerated in August and declined by 3.6% yoy in September. Weaker imports are mainly attributed to economic activity



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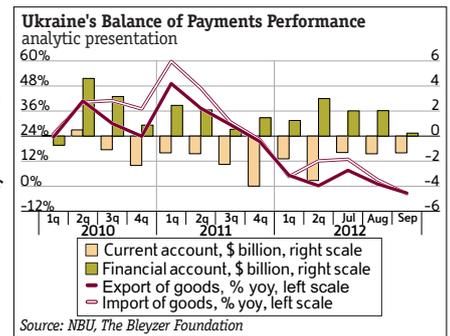
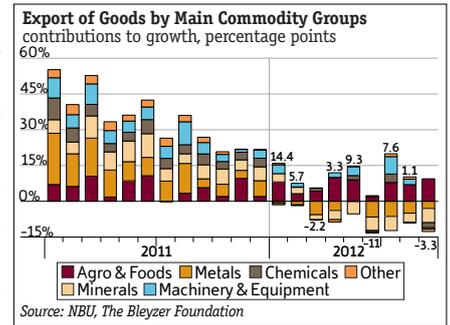
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slowdown over these two months, although lower volumes of energy imports also contributed. At the same time, as the total volume of imports exceeded exports, Ukraine's current account deficit remained high at about \$1.4 billion in both August and September. These brought nine month cumulative gap to \$9.3 billion, almost 60% higher than in the corresponding period last year. Given current trends, the deficit is likely to reach 6.5% of GDP in 2012.

In August, as in the previous months, sovereign debt borrowings and short-term capital inflows fully covered the current account deficit. Already in September, the surplus in the financial and capital account shrank to only \$0.2 billion amid trade credit repayments and higher population demand for foreign currency. In particular, net purchases of foreign currency by the population amounted to \$1.8 billion in September, which was almost 50% higher than monthly purchases over the previous three months.

The deterioration of external balances and foreign exchange market tensions signal the need for rebalancing of the Ukrainian economy, which could be partially achieved through exchange rate adjustment. At the same time, without a broader program of economic measures to restore and promote the competitiveness of Ukrainian goods, these measures would bring only temporary improvements. Hence, Ukrainian authorities should seize the opportunity of a calm political season of about two years to implement economic reforms.





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