

Macroeconomic Situation

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Summary

- In 2008, Ukraine's economic growth slowed to 2.1% yoy, pointing to a sharp contraction in the last quarter of the year. Real sector performance in January 2009 was also disappointing.
- The consolidated budget deficit constituted 1.5% of estimated GDP, about half of the target. Since the 2009 budget was developed based on overly optimistic macroeconomic parameters and targets a deficit of 3% of GDP, the fiscal stance in 2009 looks quite worrisome.
- Consumer inflation accelerated to 22.3% yoy in 2008. Inflation pressures are forecasted to ease in 2009. At the same time, spill-over of exchange rate depreciation and planned service tariffs adjustments will hamper the speed of disinflation.
- Ukraine's currency lost about 60% of its value with respect to the US Dollar in 2008. Depreciation and a deep economic downturn are challenging banking sector stability; however, monetary and government authorities are active in addressing banking sector weaknesses.
- The current account deficit widened to \$11.9 billion or 6.7% of estimated GDP in 2008. December 2008 and January 2009 current account statistics was encouraging, demonstrating a sharp reduction in imports.
- The forecasted rapid deterioration of the financial account makes the balance-of-payments position in 2009 quite vulnerable. However, with the support from international financial institutions, the situation looks manageable.
- During February 2009, two international rating agencies downgraded Ukraine's sovereign ratings.

Economic Growth

According to preliminary estimates, real GDP grew by 2.1% yoy in 2008, which suggests that the real GDP decline in December was smaller than in the previous month. A similar trend was observed in the industrial sector as its output increased 3.2% month-over-month (mom) in December. On an annual basis, industrial production contracted by 26.6% yoy, slightly up from 28.6% yoy in November. December's figure brought the cumulative industrial output

decline to 3.1% yoy in 2008. Signs of a growth rebound may be attributed to a sharp Hryvnia devaluation in 4Q 2008, which allowed Ukraine's exports to reap some competitive gains even in a weak external environment.



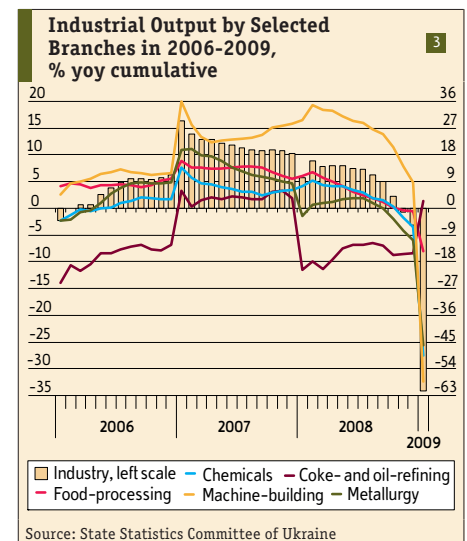
However, January's data confirmed that without strong, well-planned measures to revive economic growth, devaluation alone will not be sufficient. In addition to external weaknesses, real wages declining by about 12% yoy in January 2009, growing unemployment, hryvnia depreciation and credit tightening have caused domestic consumers to reconsider their behavior towards retrenchment of expenditures. The continuing credit squeeze and falling corporate profits are likely to have depressed investment decisions. Finally, due to a protracted gas dispute with Russia, which resulted in Russia's gas supply cut-off to Ukraine, a number of industrial enterprises were forced to reduce or stop production as available gas resources were directed to support heating and electricity producers in the

	Jan-09	Jan-08	2008
Agricultural output	0.5	0	17.5
Industrial output	-34.1	5.7	-3.1
Construction works	-57.6	-5	-16
Wholesale trade	-33.5	8.2	-6
Retail trade	-7.8	27.1	18.6
Cargo transportation	-32.3	5.8	-0.2
Passengers transportation	-5.7	3.3	4.5

Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

first place and alternative energy resources were scarce. As a result, virtually all sectors, both export and domestic market oriented, reported a dramatic downturn, the worst in more than 10 years.

Ukraine's industrial production sank by 34.1% yoy in January with metallurgy, chemicals, and machine-building being the main sources of the downfall. Production of chemicals plummeted by 49.6% yoy. Output in machine-building has dropped by 58.3% yoy on account of a 64.3% yoy decline in production of transport vehicles. Production of metals and metal posted a 46% yoy decline. The only industry demonstrating an increase in output was coke and oil-refining. Despite falling demand for coke from the metallurgical industry, low world crude oil prices, strong demand for fuel oil as an alternative to scarce natural gas, and a low statistical base allowed the industry to show a 2.4% growth in output.



Suffering from a credit squeeze, sliding housing prices, and falling private and government investments, construction showed a 57.6% yoy decline in the value of construction works. Closely linked to external trade and industrial sector performance, wholesale trade and cargo transportation turnovers declined by 33.5% yoy and 32.5% yoy respectively. A 7.8% yoy and 5.7% yoy drop in retail sales and passenger transportation reflected falling consumer demand.

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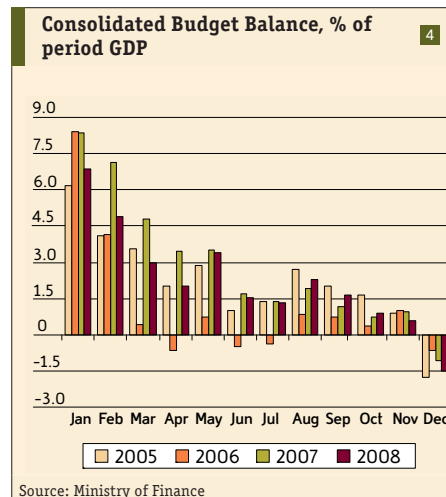
In contrast to other sectors, agriculture demonstrated an increase in output by 0.5% yoy in January 2009. At the same time, the growth was achieved mainly thanks to higher poultry and egg production, while production of other agricultural products continued to contract. Given the shortage of domestic supply of agricultural products, more expensive imports, and deterioration of consumer demand, food-processing showed a 14.3% yoy decline in output.

January's real sector developments, which were below expectations, generated further pessimism regarding Ukraine's economic outlook in 2009. As the global economy is forecasted to start recovering only in the last quarter of 2009, commodity prices for Ukraine's major exporting commodities are likely to remain weak throughout the year. Falling real household income and employment will exert a heavy toll on private consumption, while lower corporate profits, tight access to credit and weak investor sentiment reduce capital spending. Moreover, the economy will face an imported natural gas price increase of about 30% on average during 2009. On a positive note, weak domestic demand, lower energy prices and more expensive imports will help to curb imports. Overall, given the above described scenario and the estimated magnitude of GDP decline in January 2009, we've downgraded our baseline GDP forecast and now see real GDP falling by 5% yoy in 2009.

Fiscal Policy

Rapid deterioration of economic growth since October 2008 caused a sharp worsening of fiscal performance during November-December 2008 and at the beginning of 2009. In November 2008, revenues to the general fund of the state budget were 11% below target. Though the State Treasury reported only a 9.3% under-execution of budget revenues to the general fund in December, the improvement was virtual, as to a significant extent it was achieved thanks to extra revenues not foreseen in the budget law. In particular, the National Bank of Ukraine transferred to the state budget an extra UAH 3.5 billion (\$437.5 million) in December as the difference between its reve-

nuces and expenditures. Excluding this amount, December's revenues to the general fund of the state budget were under-fulfilled by 26%. Cumulatively, state budget revenues were 2.8% above target thanks to over-fulfillment of budget revenues in the first ten months of the year.



In 2008, consolidated budget revenues grew by 35.4% yoy in nominal terms to UAH 297.8 billion (\$37.2 billion). The increase was mainly achieved thanks to a 41% yoy increase in tax revenues that reflected robust growth in wages and corporate profits, booming imports and strong exports in the first nine months of the year. Due to government austerity measures (freezing public sector employees' nominal wages, cutting expenditures of government agencies, etc.) initiated in November, the consolidated budget posted a deficit of UAH 14.2 billion (\$1.8 billion), or about 1.5% of estimated GDP in 2008. The budget gap was just over half the target¹; however, it exceeded the IMF budget deficit ceiling set at UAH 9.9 billion.

The fiscal stance in 2009 looks quite worrisome. Although the government reported slight over-fulfillment of budget revenues in January by about 1%, it was achieved thanks to non-planned receipts. In particular, the NBU transferred UAH 1 billion to the budget as the difference between its revenues and expenditures. At the same time, this amount should have been paid only at the end of 1Q 2009.

Moreover, about UAH 1.9 billion of tax receipts were received as customs clearance for the natural gas imported back in 1Q 2008. Excluding these proceeds, budget revenues were under-fulfilled by more than 25%. Reliance on one-off budget revenues questions the sustainability of budget revenues in the coming months, thus indicating the need for a downward revision of budget parameters. However, the forthcoming presidential election (scheduled for early 2010) looks like an increasing constraint on the government to maintain fiscal prudence.

Since 2004, the Ukrainian government has followed a pro-cyclical fiscal policy, which was partially attributed to short election cycles in the country. Generous social spending allowed for raising living standards as well as gaining popularity. Despite a notable increase in budget expenditures, the government maintained fiscal deficits at about 1% of GDP thanks to robust growth in tax revenues, which were the result of booming external trade, buoyant consumption growth and some improvement in tax administration. Loose fiscal policy is partially responsible for the economic difficulties the country is currently facing as the population's growing purchasing power amid limited domestic supply of consumer goods was increasingly satisfied via imports. Rapidly widening trade and current account deficits made the country particularly vulnerable to adverse external shocks. At the same time, a heavy budget bias towards social spending (current expenditures accounted for more than 85% of total consolidated budget expenditures in 2008) left little scope for non-inflationary fiscal stimuli for the Ukrainian economy during crisis times.

Though the Ukrainian government committed to maintaining a balanced budget in 2009, it came up with a deficit of more than 3% of GDP and revenues developed on a quite optimistic macroeconomic forecast. Given tight global financial conditions, foreign investors' risk aversion and the severity of the economic downturn in Ukraine, the government hopes to raise the necessary budget deficit financing on the domestic market. However, given the banking

¹ According to the Budget Law amended on December 12th, 2008, the targeted budget deficit was raised to UAH 25 billion, or almost 2.6% of GDP.

sector weaknesses and unattractive yields on domestic securities, the only feasible option to finance the deficit is monetizing it.

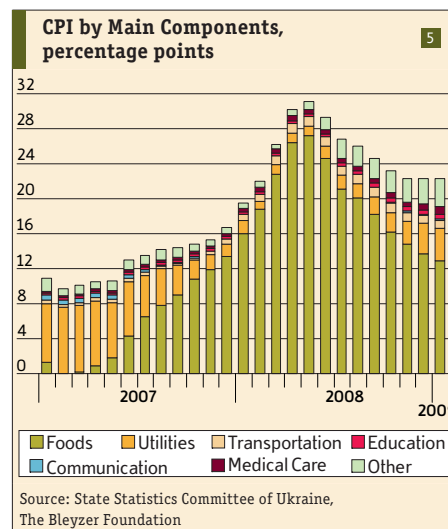
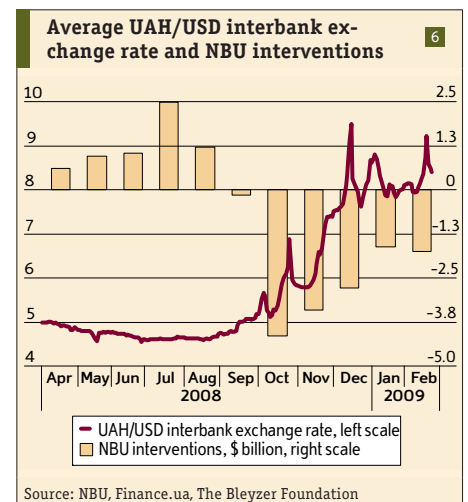
In the aftermath of the financial and economic crises during the 1990s, direct NBU financing of government expenditures was forbidden by law. However, 2009 budget innovations allow the government to by-pass this ban. According to Article 84 of the 2009 budget law, the government has obliged the NBU to buy out government securities from commercial bank portfolios within three days of the banks' request. Direct monetary financing of the budget deficit undermines the central bank's ability to conduct independent monetary policy and raises the risks of losing control over inflation.

The inflationary sources of budget deficit financing rather than the size of the budget deficit target per se were among the main reasons for the IMF program delay in February 2009. At the same time, the program did not foresee the magnitude of the economic downturn observed during November 2008-January 2009. Hence, the IMF has been considering the relaxation of the program requirements for Ukraine at the request of the government authorities. According to preliminary information, the Fund may agree to have larger fiscal deficit if there are realistic revenues and non-inflationary sources of its financing such as funds from other international institutions (the World Bank, EBRD, etc.) and individual countries. Though the Ukrainian government is actively seeking such financing, the budget is likely to be revised during March-April 2009 to reduce the deficit and revise budget revenues.

Monetary Policy

Monthly consumer price inflation accelerated during December 2008-January 2009. The CPI index grew by 2.1% mom and 2.9% mom respectively driven by an upward revision of utility tariffs and spill-over effect of Hryvnia depreciation. The impact of the latter was the most pronounced for price growth on transport vehicles, household appliances and pharmaceuticals as the lion's share of these commodities is imported. The depreciation of the national currency has also undermined the benefits from the declining world commodity

prices. In particular, despite the continuing slide of world crude oil prices, Ukraine's domestic fuel and gasoline prices grew by 10.2% mom in January 2009. In annual terms, consumer inflation remains unchanged at 22.3% yoy since November 2008. Thanks to favorable statistical base effect, the NBU measures to smooth the exchange rate adjustment and falling domestic demand are likely induce disinflation in the coming months. At the same time, the speed of this process will be hampered by continuing tariff adjustments to cost-covering levels, monetary financing of the fiscal deficit and rapid dollarization of the economy. Thus, consumer inflation is forecasted to stay at around 15% at the end of the year.



Though the Ukrainian currency lost about 60% of its value with respect to the US Dollar in 2008, depreciation pressures still remain rather strong. Foreign trade and current account balances started to improve in December 2008 and January 2009, but the supply of foreign currency to the country was quite modest. On the other hand, a substantial portion of external private debt maturing in 2009 as well as a surge in population demand for foreign currency continued to pressure the exchange rate.

The National Bank of Ukraine was tolerant of foreign exchange depreciation but tried to smooth the process by selling its international reserves. Though it spent about \$11 billion in 4Q 2008 and another \$3.3 billion in Janu-

ary-February 2009 to prevent a free-fall of the currency, the foreign exchange market remained extremely volatile with the Hryvnia sometimes approaching 9.5 with respect to the US Dollar. The periods of sharp Hryvnia depreciation tend to be explained by speculative behavior of some market participants. Though we do not reject such an explanation, we believe that the causes of such developments are rooted in the government and monetary authorities' inability to increase public confidence in the financial crisis resolution measures. In turn, weak public confidence was the result of the lack of transparency and consistency in the NBU measures to stabilize the market as well as poor coordination between the government and monetary authorities in addressing the crisis. Recently, however, there were some improvements. The NBU has issued a number of resolutions regulating its forex market intervention policy, it started to regularly inform the public about the measures taken to address banking sector weaknesses, raised the quality and expanded the content of BoP and monetary statistics, etc.

The deposit outflow continued in January 2009. A 13% mom growth in corporate Hryvnia deposits and a 3% mom increase in corporate FX deposits may be attributed to the precautionary accumulation of foreign currency to meet foreign debt liabilities as well as the rational strategy to minimize foreign exchange risk in a volatile market. In contrast, households kept withdrawing deposits. In Janu-

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ary 2009, the stock of household deposits declined by UAH 7.9 billion (\$1 billion) or 3.6% mom. The NBU's data suggests that the lion's share of withdrawn deposits were converted into cash foreign currency as net population purchases of cash foreign currency amounted to \$585 million. The ongoing flight of deposits, the liquidity squeeze due to limited NBU refinancing and "sterilization" effect of the NBU's sale of international reserves, and rising non-performing loans (due to increasing unemployment and Hryvnia depreciation) affected banking system stability. At the same time, the monetary and government authorities are active in addressing the current challenges faced by the banking system. The NBU has carried out an extensive audit of the largest commercial banks and is currently implementing diagnostics of smaller banks. The majority of banks were asked to provide additional capital and 9 banks have been put under NBU administration. One of the first banks put under temporary NBU administration was stabilized and sold to new shareholders. Together with the government, the NBU has been developing a comprehensive banking sector resolution strategy. Though further stresses in the banking system are likely, these efforts will help to minimize their impact and facilitate recovery.

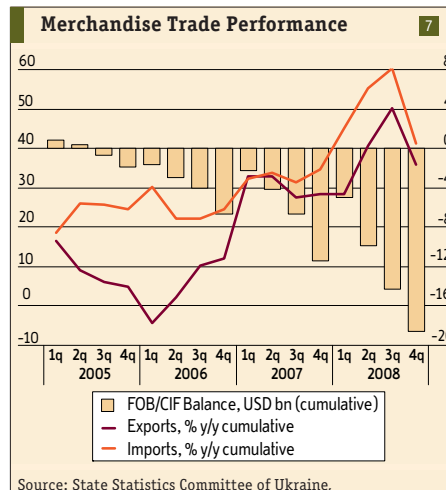
International Trade and Capital

Due to weak external demand and low international commodity prices, Ukrainian exports contracted sharply during November-December 2008. On average during these two months, exports of chemicals, metallurgical products, machinery and transport equipment, which together account for about 2/3 of total merchandise exports, fell by about 34% yoy, 40% yoy and 20% yoy respectively. However, thanks to faster growth of agricultural products exports (particularly, grain) and decent increase in exports of food and mineral products, total exports declined by 16% yoy on average during November-December 2008.

Affected by sharp Hryvnia depreciation and rapidly deteriorating industrial performance, imports have also started to decline since No-

vember. In December, imports fell by 27.3% yoy, much faster than exports. As a result, December's monthly merchandise trade deficit of \$0.8 billion was almost twice as low as the average monthly deficit over the first eleven months of the year. At the same time, the cumulative foreign trade deficit continued to widen and reached a record high \$18.5 billion. Correspondingly, the current account deficit amounted to \$11.9 billion, or 6.7% of estimated full-year GDP. Moreover, the deepening global economic recession, tight international liquidity and sharp deterioration of Ukraine's macroeconomic parameters have dried up long-term capital inflows to Ukraine and increased short-term capital outflow from the country. Thus, in 4Q 2008, Ukraine re-

ports fell by 32% yoy, imports contracted by 50% yoy. As a result, Ukraine registered merchandise trade and current account surpluses of about \$200 million and \$500 million respectively. Such a sharp drop in imports is attributed to weak domestic demand, declining world commodity prices and crude oil prices in particular. At the same time, due to the gas dispute with Russia, which caused a halt in Russia's natural gas supply to Ukraine during most of January, Ukraine's import of mineral resources was abnormally low that month. Though resumed natural gas imports and higher negotiated price for natural gas will cause imports to increase in the coming months, weak domestic demand as well as government measures to curb imports will help to mitigate this impact.



ceived only \$1.2 billion of net FDI inflows, compared to \$8.7 billion in the first nine months of the year. Moderate FDI and other capital inflow amid portfolio investments outflow and large external private sector debt repayments resulted in a financial account deficit of \$5.7 billion in 4Q 2008. Though cumulatively the financial account stayed in surplus of about \$8.8 billion in 2008, it did not cover the current account gap. As a result, the difference was absorbed through the reduction of the NBU's gross international reserves and Hryvnia depreciation.

Preliminary balance of payments statistics for January 2009 were encouraging. Though ex-

A faster decline in imports than exports will allow Ukraine to cut its foreign trade deficit in 2009 compared to 2008. The current account deficit is forecasted to narrow to about \$4 billion or 3.6% of GDP in 2009. Ukraine's large external debt servicing requirements will continue to pressure the exchange rate. At the same time, with a number of parent banks announcing capital support for Ukrainian subsidiaries, financial support from the IMF and other international financial institutions², the net foreign financing gap estimated at about \$10 billion looks quite manageable.

Other Developments Affecting Investment Climate

During February 2009, both Fitch and Standard and Poor's downgraded Ukraine's sovereign ratings from "B+" to "B" and "B/B" to "CCC+/C" respectively and maintained the negative outlook for further rating revisions. The rating downgrade reflected rapidly deteriorating macroeconomic conditions in Ukraine, the fragile banking sector stance, the lack of policy consensus among various authorities and increased risks for successful execution of the IMF program. Moody's has also put Ukraine's rating under review, hinting at a likely downgrade.

² Although the IMF program was delayed in mid-February, we believe there is high probability that the program will be resumed during March-April 2009.