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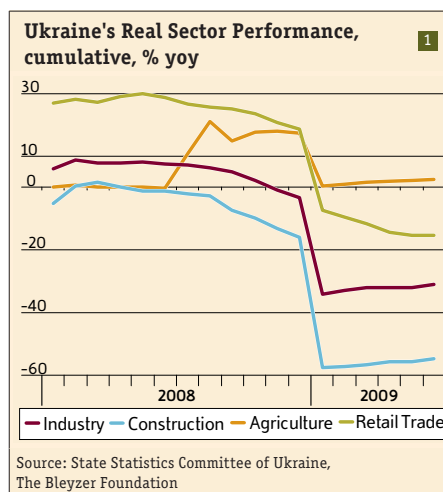
### Summary

- May-June real sector data provided evidence that the bottom in economic activity may have already been reached. However, despite the early signs of improvement, we have downgraded our GDP forecast for 2009.
- A deep economic downturn caused significant deterioration of fiscal accounts, although the government tried to be economical in describing budget performance. The size of the overall fiscal deficit (including the pension fund, Naftogaz and bank recapitalization costs) may exceed 11% of GDP in 2009.
- As the government has been working to secure sufficient external resources to cover the fiscal gap and considering depressed economic activity, such a large fiscal deficit may have limited pressure on inflation this year. However, an increasing public debt burden in forthcoming election years (2010-2011) and a slow economic recovery raises serious concerns over the sustainability of public finances in the medium-term.
- The disinflation trend, observed in the first five months of the year, reversed in June-July. With both upward and downward pressures to be present in 2H 2009, consumer price inflation is forecasted to stay at around 15% yoy in 2009.
- Following stabilization of the foreign exchange market over April-June, depreciation pressures resumed in July. The market is expected to remain volatile through the rest of the year, depreciating to UAH 8.5-9.0 per US Dollar.
- During June-July, good progress in dealing with the banking sector difficulties was observed. However, the risks in the banking system remain significant.

### Economic Growth

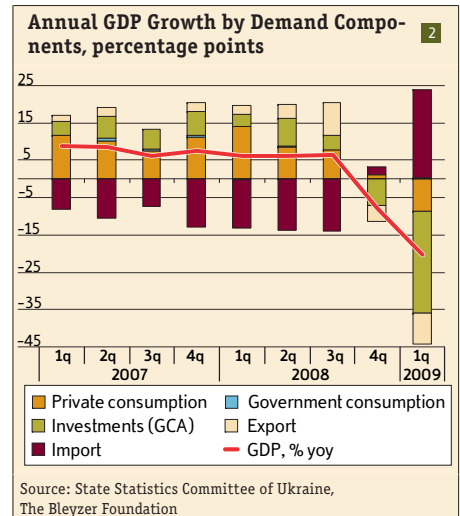
Following the first signs of stabilization in March-April, real sector data for May and particularly June provided additional evidence that the drop in activity may have already reached bottom. In particular, the pace of output contraction in a number of key sectors, such as industry, retail trade, transportation and construction, moderated in June. This sentiment is supported by growing 'green shoots' in the data of a number of developed countries

(the US, EU-15) as well as emerging markets (China, Brazil). However, despite improved global economic prospects, we expect Ukraine's economic recovery to be quite slow and weak. Moreover, we have worsened the near-term outlook for Ukraine. The forecast revision reflects i) the severity of the economic downturn in 1Q 2009, ii) weak economic activity in 2Q 2009, and iii) strained financial market conditions.



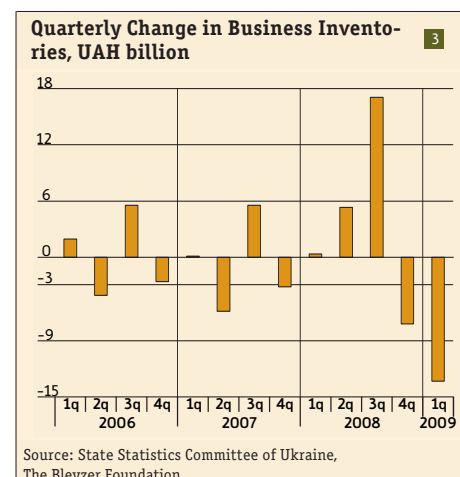
According to the provisional national accounts for the first quarter of 2009, real GDP fell by 20.3% compared to the corresponding quarter of 2008. Amid a sharp decline in external demand, Ukraine's real exports of goods and services fell by 16% yoy. However, Ukraine's demand for imports declined even more sharply - more than 35% yoy, softening the decline in real GDP. Increased unemployment (from 7.5% in 4Q 2008 to 7.5% in 1Q 2009, ILO methodology) and a large decline in real household income (by almost 13% yoy in 1Q 2009) have weighed on consumption. Consumer spending was down 11.6% yoy, but less than we anticipated and at a smaller rate than the drop in real income. Spending was apparently supported by savings made in previous years.

Deterioration in investment activity was particularly severe, much worse than we expected. In particular, investments into fixed capital declined by almost 50% yoy in real terms. Facing lower demand (both domestic and external), declining corporate profits and tight access to credit resources, corporate enterprises have revised their investment plans downwards. More-



over, entering 2009 with very high inventories (UAH 15.5 billion, or \$1.9 billion), despite the run-off in the fourth quarter of 2008, enterprises continued to aggressively destock inventories in 1Q 2009. Considerable inventories at the beginning of 2009 may be another explanation for the sharp decline in industrial output as well as imports observed in the first half of 2009.

Despite some improvement in June, available data suggests that the rate of economic decline in 2Q 2009 may be comparable with that in the first quarter of 2009. In particular, retail sales turnover, frequently taken as a proxy for consumption, declined by 15.2% yoy in 1H 2009 on a cumulative basis compared to a 11.5% yoy drop in 1Q 2009. Preliminary external trade statistics for May-June was remarkably weak. Although imports fell even sharper in



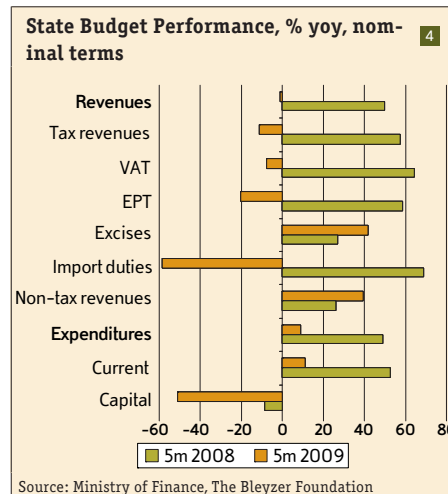
2Q 2009, to a large extent this was achieved on the back of lower volume of imported energy resources. The latter was not only the result of depressed economic activity, but also delays in the import of natural gas to be pumped into gas storage to secure continuous gas transit during the next heating season. Imports of fossil fuels are likely to receive strong impetus in the second half of the year. Investment activity is likely to remain depressed amid poor credit availability and firms' deteriorating financial conditions. Some improvement, supported by inventory rebuild, may be expected in the second half of the year.

At the same time, with a deeper and likely longer economic recession than was previously anticipated, there is growing concern over the possibility of a second wave of the financial crisis, now related to the growth of non-performing loans accumulated by the banks. Although the NBU has already performed diagnostic stress-tests for most banks and requested that the banks raise their capitalization (either by the shareholders' or the state), the capital projection may be insufficient to deal with the ongoing problems in the banking sector as the test was based on a 9% GDP contraction in 2009. At the same time, even if the second wave of the crisis is avoided, the process of cleaning up commercial banks' balance sheets (which is likely to be protracted) and the virtually closed debt markets will undermine the banks' ability and willingness to resume credit, thus dragging on real growth. All these considerations made us reduce our GDP growth forecast for Ukraine from the previous -8% to almost -14% in 2009.

### Fiscal Policy

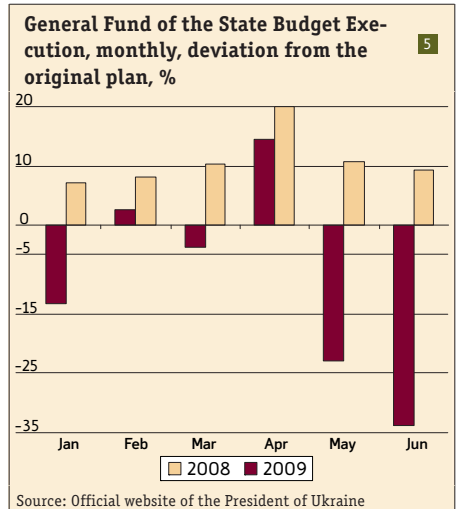
A deeper than initially forecasted economic recession has intensified concerns about the sustainability of Ukraine's fiscal accounts. At first glance, the budget revenue statistics delivered by the government did not underline the challenges state finances were facing. In particular, the government kept reporting above-planned budget revenues in May-June. Thus, according to the government, referenc-

ing the State Treasury, proceeds to the state budget were over-fulfilled by 4.6% in January-May and by 4.1% in January-June. Moreover, total state budget revenues were down less than 1% in nominal terms in the first five months of 2008 compared to the respective period last year. The Ukrainian authorities used successful execution of budget revenue targets as an argument to explain their reluctance to carry out fiscal adjustment. At the same time, a deeper fiscal data reading revealed significant fiscal deterioration, raising worries about the likely size of fiscal deficit as well as the sources of its financing.



The declared over-fulfillment of state budget revenues became possible thanks to a downward revision of the targets. Thus, according to the original plan, revenues to the general fund of the state budget actually collected were more than 10% below target in 1H 2009.<sup>1</sup> Moreover, collections to the budget notably deteriorated in May-June. In the previous months, the government relied heavily on one-off proceeds and early payments of tax bills and other charges. However, being inherently unsustainable, these sources of funds may have started to dry up.

Over the first five months of 2009, tax receipts to the state budget declined by 11% yoy in nominal terms. The deterioration came mostly from corporate profit tax, VAT and import duties. The decline in revenue was particularly



pronounced for corporate proceeds, which have plunged by more than 20% in nominal terms. Import duties declined almost 60% yoy in line with a sharp drop in import values over the respective period. VAT revenues, which account for almost 60% of total tax proceeds, have fallen by 7.5% yoy over the period. On the upside, state budget revenues were supported by non-tax collections and excise proceeds, which went up by about 40% yoy each in nominal terms.<sup>2</sup> At the same time, the situation with budget revenues looks even more worrisome considering increased VAT refund arrears, resumed mutual offset deals between the budget and enterprises (mainly state-owned) as well as advance tax payments.

In contrast to revenues, state budget expenditures proved to be inelastic, advancing by 9% yoy in January-May 2009. An increase in expenditures occurred on the back of increased social spending (due to an increase in the minimum wage, medical spending, etc.). Thus, current spending grew by 11.2% yoy over the first five months of the year, while capital expenditures fell by more than 50% yoy. As a result of falling revenues amid growing expenditures, Ukraine's consolidated budget gap widened to UAH 3.2 billion (\$0.4 billion) in January-May 2009. A consolidated budget deficit this high has not been seen in ten years. Moreover, we believe the major deterioration in fiscal ac-

<sup>1</sup>Source: Economic and Social Development Chief Service at the Secretariat of the President of Ukraine.

<sup>2</sup>An increase in excise payments is related to a rise in excise tariffs on tobacco and tobacco products. Larger non-tax revenues reflect an early payment of the positive difference between the NBU's revenues and expenditures in 2008 to the budget.

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counts will occur in the second half of the year. Despite an expected improvement in economic activity in 2H 2009, particularly in the last quarter of the year, budget revenues may remain depressed due to early payment of taxes in the first half of the year. On the other hand, expenditures are likely to increase due to their seasonal nature (typically expenditures rise markedly in the last couple of months of the year) and delivery of fiscal stimulus (to the agricultural sector, construction, mining, etc.). Plus, there may be growing pressure to increase budget spending in the run-up to presidential elections scheduled for January 17<sup>th</sup> 2010.

Also noteworthy, the reported consolidated budget deficit does not account for the pension fund deficit and quasi-fiscal deficit (imbalances of state-owned enterprises, primarily Naftogaz). According to pension fund authorities, the fund's revenues stood at UAH 71.2 billion in 1H 2009, 4.3% above target. There is evidence that the plan was revised downwards. At the same time, planned expenditures in the amount of UAH 81.1 billion were fully executed. As a result, the pension fund deficit amounted to almost UAH 10 billion (\$1.3 billion) in 1H 2009, or about  $\frac{3}{4}$  of the targeted amount for the full year. The fund's higher than expected deficit was covered by the cash balances accumulated in the previous year and loans from the state budget. Although the situation with the pension fund is likely to improve in the second half of the year (in mid-April, the government approved a number of corrective measures - capping maximum pensions, increasing deductions to the pension fund for entrepreneurs who chose a simplified taxation system), the end-year deficit may be wider than foreseen in the budget.<sup>3</sup>

The financial stance of the state-run natural gas monopoly Naftogaz Ukrainy raises serious concerns. The deep economic crisis, high indebtedness (particularly foreign) and a wide gap between imported natural gas prices and the sale prices to households and heating companies have put the company's ability to meet its obligations in question. Although the gov-

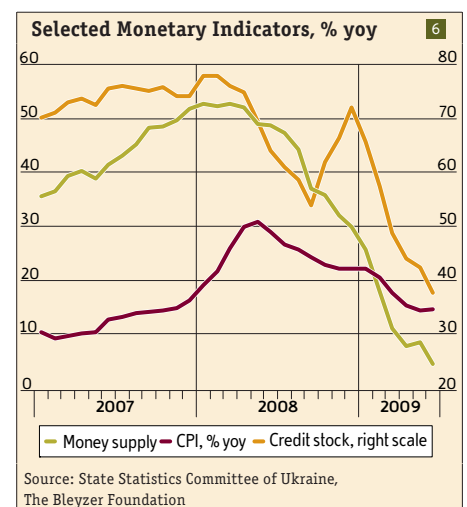
ernment approved a number of measures to improve the company's financial situation - boosting the company's capital by UAH 18.6 billion (\$2.4 billion), approving a 20% price increase for households in September and for heating companies in October, as well as developing a schedule of quarterly price increases since the beginning of 2010 - Naftogaz's net financing needs were still estimated at about 2.5% of GDP in 2009.

Given all the above and adding the planned financing of bank resolution program, the total fiscal deficit of Ukraine may exceed 11% of GDP. So far, the government has relied on the issuance of domestic debt securities to finance the deficit (the lion's share of which was bought by commercial banks, and then were re-purchased by the Ukrainian banks or directly by the NBU) as well as external financing. With closed external financial markets, Ukrainian authorities have been working to secure external financing from a number of international financing institutions (the World Bank, EBRD, etc.). Moreover, it was agreed with the IMF that half of the second and all of the third tranches would go to finance government and quasi-government external obligations. Recently, a consortium of international financial institutions announced it is considering an offer of a \$1.7 billion loan for Naftogaz's financing needs. The loan will be conditional on a number of reform efforts in the energy sector of Ukraine. Furthermore, in June the government expressed its firm intention to resume the stalled privatization process and offered for sale a number of potentially interesting enterprises (Odessa port plant, several oblenergos). Amid depressed economic activity and with all of these funds successfully obtained, the impact of such a high fiscal deficit on inflation may be rather limited in 2009. However, with a slow recovery in 2010, a high social security net burden and 2010-11 being election years, Ukraine risks running high budget deficits beyond 2009. Hence, restoring/maintaining fiscal prudence will be on the agenda for Ukraine in the medium term.

### Monetary Policy

As expected, following rather fast disinflation from 22.3% yoy in January to 14.7% yoy in May 2009, the trend reversed in June-July. In particular, the consumer price index gained 1.1% mom in June, bringing consumer price inflation back to 15% in annual terms. While food price growth continued to be on a downward trend falling below 9% yoy in June, a rise in total CPI was supported by faster price growth for tobacco and alcohol, utilities and transportation services. Thus, due to a more than twofold increase in excises on tobacco and tobacco products, prices on these commodities grew by 9.5% mom in June and were 40% higher than in June last year. The scheduled tariff adjustment on railway transportation and further increase in fuel prices explain a 3% mom price increase in the transportation sector. Utility services were 4.1% mom more expensive in June, mainly on account of tariff adjustment in Kyiv, the capital of Ukraine. However, the suspension of the utility tariffs increase in July caused a 3.3% mom downward adjustment in the utility services price index that month. Moreover, food prices seasonally went down by 0.2% mom in July. However, as the favorable statistical base effect vanished, annual consumer inflation picked up to 15.5% in July.

Weaker consumption, decelerating money supply growth and tighter credit should exert



<sup>3</sup>According to the Ukrainian legislation, the deficit of the Pension Fund of Ukraine should be covered by the state budget funds. State Budget Law foresaw a UAH 13.5 billion gap between revenues and expenditures of the Pension Fund of Ukraine in 2009.

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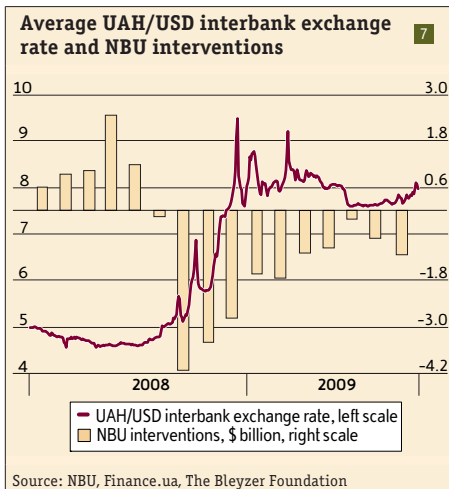
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### Macroeconomic Situation



downward pressure on consumer prices. However, its impact is likely to be offset by planned increases in utility tariffs (natural gas prices for households will be raised by 20% in September; suspension of utility tariffs adjustment in Kyiv may be temporary, though the scale of adjustment may be lowered). As a result, we maintained our forecast of end-year inflation at 15% in 2009. Observing good disinflation progress and stabilization of the exchange rate market during May-June, the NBU reduced its discount rate by 100 basis points to 11%, effective mid-June.

The foreign exchange market has been virtually stable during June, supported by the NBU interventions, regular foreign currency auctions as well as administrative measures that restrained commercial banks' forex transactions. At the same time, to secure a successful IMF program review, the NBU committed to softening administrative regulation of the foreign exchange market. This decision concurred with the improved liquidity in the banking system as well as increased demand for foreign currency, causing higher volatility of the Hryvnia-Dollar exchange rate since the end of June.

The liquidity of the banking system notably improved in June-July, evident from the increased cash balances on the banks' correspondent accounts and rather low interest rates on the interbank market. While the reduction of the NBU discount rate may have a limited effect, better liquidity in the Ukrainian banking system was attributed to a drop in deposit withdrawal, the sale of government securities from the banks' portfolios and NBU support with its refinancing resources (the NBU provided UAH 8.9 billion of refinancing support in June alone). All of this came on the back of virtually stalled credit activity.

The stock of commercial bank loans to the economy of Ukraine declined by 2.6% from January to June 2009. At the same time, excluding loans of state-owned banks to state-run companies (e.g., to finance Naftogaz purchases of natural gas), the drop in credit would be much more pronounced. Excess liquidity may have been directed to the foreign exchange market, causing higher volatility since the end of June. Recent NBU decision to tighten reserve requirements<sup>4</sup> for commercial banks may be linked to such practices. Uncertainty regarding the disbursement of the third tranche under the IMF program, the accumulation of foreign currency to service/repay external debts as well as expectations that depreciation pressures will intensify in the fall of this year spurred the demand for foreign currency. Combined with limited supply of foreign exchange due to depressed foreign trade, these factors led to a 5% depreciation in the average Hryvnia exchange rate to UAH 8.0 per USD on the interbank forex market in July. Due to large debt services maturing in the second half of the year, the likely worsening of the foreign trade balance, growing political instability ahead of the presidential election and concerns over banking sector stability, the exchange rate is likely to remain volatile through the rest of the year, depreciating to UAH 8.5-9.0 per USD.

Despite some recent progress in dealing with banking sector difficulties, the risks in the banking sector remain significant. On a positive note, the run in bank deposits have ceased in 2Q 2009. Following the NBU's stress tests and requests for additional capitalization, the capital of most first-tier (mainly subsidiaries of foreign banks and state-owned banks) and a number of the second-tier banks were boosted by existing shareholders. Seven large banks were recommended for state recapitalization with three of them recapitalized in mid-June 2009. Moreover, a number of international financial institutions (the EBRD, the WB, etc.) have allocated about \$2 billion to support Ukraine's commercial banks by acquiring minority stakes. On the other hand, the likely Hryvnia depreciation in 2H of 2009, high debt service repayments and deteriorating quality of commercial banks assets<sup>5</sup> increase the likelihood of further stresses in the banking sector.

#### International Trade and Capital

Following a sharp reduction in 1Q 2009, Ukraine's current account kept rapidly adjusting during the second quarter of the year. According to preliminary data, the current account reported a surplus of \$160 million in 2Q 2009. The adjustment largely reflects the narrowing in Ukraine's trade deficit, which stood at \$1.8 billion in 1H 2009, almost 2.5 times lower than in the respective period last year. Although export performance deteriorated in 2Q 2009, imports fell even more sharply. In particular, exports dropped at an annual rate of 51% in the second quarter, exceeding the 39% yoy decline in 1Q 2009. Import of goods fell by 58% yoy in 2Q 2009, with imports of machinery and transport vehicles showing particularly strong declines. The deterioration of goods imports this year was influenced by sharp Hryvnia depreciation in the fall of 2008, import restrictions, low world commodity prices and falling domestic demand. At the same time, the trend may start to reverse in the coming months, affected by resumed growth in en-

<sup>4</sup> According to Ukrainian legislation, commercial banks have to build their reserves on a daily basis. However, during the day these funds could be used for commercial banks operations but should be replenished by the end of the day. In mid-July, the NBU issued a resolution that starting August 3<sup>rd</sup>, 2009, commercial banks will have to accumulate 40% of their daily reserves on a special account with the NBU. Commercial banks will not have access to these funds during the day.

<sup>5</sup> According to the NBU, the level of non-performing assets (doubtful and loss loans) grew from less than 4% at the end of 2008 to almost 9% at the end of June 2009. However, actual asset quality may be much worse as the existing practice of defining NPLs in Ukraine does not include substandard loans and allows for manipulations when classifying the loan as sub-standard or doubtful. According to various estimates, NPLs may account for 17-25% of total commercial banks' loans.

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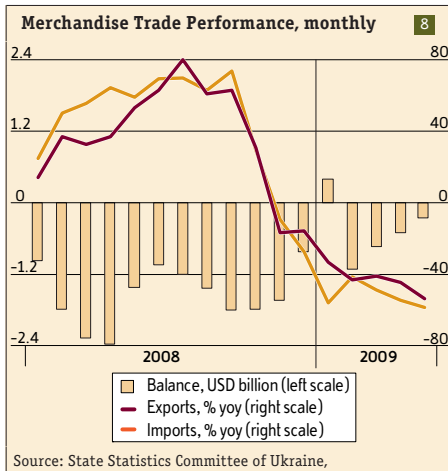
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ergy products and larger volumes of natural gas imports (necessary to pump into Ukraine's underground storages to secure smooth gas delivery during the peak consumption in winter). Moreover, demand for imports may also start to recover in 2H 2009, reflecting the need to replenish inventories (due to sharp destocking in 1H 2009). Although the rate of export decline is likely to decelerate in 2H 2009 as the global economy shows signs of improvement, the current account gap is likely to widen in 2H 2009.

Similar to the current account, the capital account balance also improved in 2Q 2009. Thanks to the stabilization of the foreign ex-

change market, resumption of the IMF stand-by agreement for Ukraine and financing from other international financial institutions, Ukraine successfully met its external financing needs for 1H 2009. Although external debt financing needs are estimated to intensify in 2H 2009, with growing evidence of successful private debt restructuring/refinancing amid available financing from IFIs, the gap may exert relatively moderate pressure on the exchange rate.