

January 2013

- In 2012, industrial production was down by 1.8% yoy as weakening global demand for steel exerted a toll on the Ukrainian metallurgical industry.
- Last year, Ukraine harvested 46.2 tons of grains and overseas shipments of grains more than doubled, which testifies to the growing export potential of Ukrainian farming.
- In January-November, the state budget deficit (excluding payments to cover the Naftogaz deficit) stood at about 3% of projected full year GDP.
- Thanks to falling food prices, stable energy prices and flat utility tariffs, consumer prices barely changed in 2012.
- In January-November 2012, the current account gap widened to \$12.5 billion (or about 7% of projected full year GDP), which is nearly 40% yoy higher than a year ago.

Executive Summary

Goods-producing sectors, which jointly account for about 36% of Ukrainian GDP, were a drag on economic growth in 2012 as production indices in agriculture, industry and construction moved into negative territory. The Ukrainian economy remains particularly sensitive to global business cycles as lagging world demand for steel exerted a toll on the local metallurgical industry. Indeed, a 5.2% yoy drop of output in metallurgy was a major reason behind a stalled industrial recovery. On the upside, the global economy appears to be stabilizing as recent economic data from China points to an acceleration of growth at the end of 2012. The Euro zone crisis is gradually subsiding, which, coupled with more optimistic economic data from the U.S., implies stronger economic outlook for the developed world in 2013. All of this bodes well for Ukraine as it means that foreign demand for exports is unlikely to drop sharply and may even return to modest growth later in 2013.

Agriculture was a bright spot of the Ukrainian economy in 2012 – the value of grain exports doubled and now accounts for about a tenth of all overseas shipments of Ukrainian goods. These developments are evidence of the huge export potential of Ukrainian farming, which may eventually offset the impact of the less dynamic performance of traditional export commodities, such as metals and chemicals.

Lastly, buoyed by growing wages and more generous government spending on social welfare programs, Ukrainian consumers continued spending. Retail sales jumped by 15.9% yoy, while spending on food services saw a robust gain of 8.2% yoy. Overall demand for services, such as education and healthcare, remained fundamentally strong, as the volume of non-financial services grew by 8.7% yoy, which partly offset output losses in goods-producing sectors of the economy.

Growth of consolidated budget revenues and spending remained on divergent trajectories at the end of 2012. In January-November, consolidated budget revenues grew by 10% yoy, while spending increased by 17%

yoy. As a result, the state budget deficit widened to 2.9% of projected full year GDP (excluding payments to cover the Naftogaz deficit, which may add another 2% to the 2012 budget deficit). In comparison, last year, the state budget deficit was only 1.7% of GDP in January-November.

Thanks to stable prices of foods, consumer prices barely changed in Ukraine in 2012. In fact, at 0.6% yoy, annual inflation posted its lowest reading in ten years. In December 2012, consumer prices were even a bit lower than a year ago as food prices dropped by 2.3% yoy. Relatively modest gains of fuel prices, which in December were up by only 6.9% yoy, and flat utility tariffs contributed to overall price stability as well. On that note, a growing need to raise utility tariffs to reduce budget spending may emerge as a major driver of inflation in 2013. In addition, despite the current lull on international commodity markets, world prices of fuels and foods may start to grow as the global economic recovery gains traction. All of this points to somewhat higher inflationary pressures in 2013.

Slower growth of exports than imports continued to widen the current account gap. According to preliminary data of the National Bank of Ukraine, the current account deficit for January-November 2012 reached \$12.5 billion (or about 7% of projected full year GDP) which is 38.1% higher than a year ago. On the upside, thanks to \$685 million net FDI inflow in November, Ukraine received almost the same amount of FDI in the first eleven months of 2012 as a year ago, despite less favorable global investor sentiment and higher political uncertainty in the second half of 2012. These FDI inflows, however, were not enough to cover the external funding needs of Ukraine, which were higher in 2012 due to the repayment of IMF loans (the government and the central bank paid back \$3.4 billion to the IMF in 2012). As a result, last year, the foreign exchange reserves of the National Bank declined by \$7.6 billion to \$24.5 billion at the beginning of 2013.

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	2009	2010	2011	2012 ^e	2013 ^f	2014 ^f
GDP growth. % yoy	-14.8	4.1	5.2	0.2	2.0	4.0
GDP per capita. \$	2 545	2 974	3 608	4 000	-	-
Industrial production. % yoy	-21.9	11.2	7.6	-1.8	-	-
Retail sales. % yoy	-16.6	9.8	14.7	15.9	-	-
Budget deficit. % GDP ^g	-8.9	-7.0	-4.4	-5.0	-3.5	-2.5
Government external debt. % GDP	20.5	23.8	21.0	19.0	-	-
Inflation. eop	12.3	9.1	4.6	-0.2	8.0	6.0
Gross international reserves. \$ billion	26.5	34.5	31.8	24.5	25.0	27.0
Current account balance. % GDP	-1.5	-1.9	-5.5	-8.1	-6.5	-6.1
Gross external debt. % GDP	88.2	86.0	76.6	73.0	-	-

^eIncluding 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).
^fRevised data for 2009-2010.

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

Economic Growth

Goods-producing sectors, which jointly account for about 36% of Ukrainian GDP, were a drag on economic growth in 2012 as production indices in agriculture, industry and construction moved into negative territory. In particular, industrial output inched down by 1.8% yoy following two years of a strong recovery, construction dropped by nearly 14% yoy while output in agriculture declined by 4.5% yoy. The Ukrainian economy remains particularly sensitive to global business cycles as lagging world demand for steel exerted a toll on local industrial production. Indeed, a 5.2% yoy drop of output in metallurgy (versus an increase of 8.9% yoy in 2011) was a major reason behind the stalled industrial recovery. A 6% yoy contraction in machine building, another important export-driven sector of Ukraine, indicates that the softness of foreign demand may be spreading across key export markets. Still, a 7% output gain in the petrochemical industry, which produces many staple export commodities of Ukraine (such as fertilizers), is a sign of continued resilience in some vital export destinations.

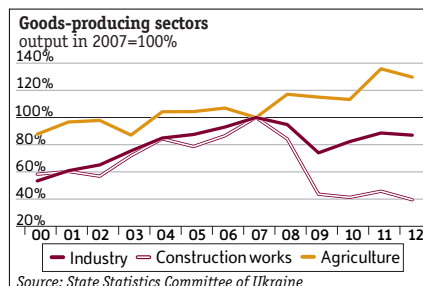
On the upside, the global economy appears to be stabilizing as recent economic data from China points to an acceleration of growth at the end of 2012. The Euro zone crisis is gradually subsiding, which, coupled with more optimistic economic data from the U.S., implies stronger economic outlook for the developed world in 2013. In fact, the IMF now expects the global economy to pick up speed in 2013, when world economic growth is projected to hit 3.5% yoy versus 3.2% yoy in 2012. All of this bodes well for Ukraine as it means that foreign demand for exports is unlikely to drop sharply and may even return to modest growth later in 2013.

Agriculture, despite a nearly 20% yoy drop of grain harvest to 46.2 million tons, was a bright spot of the Ukrainian economy in 2012. First, notwithstanding unfavorable weather conditions, grain yields remained well above their ten-year average, which most likely reflects the impact of the growing private investments in farming. Second, 2012 was perhaps the best year for agricultural exports in Ukraine – the value of grain exports doubled and now accounts for about a tenth of all overseas shipments of Ukrainian goods. These developments are evidence of the huge export potential of Ukrainian farming, which may eventually offset the impact of less dynamic performance of traditional export commodities, such as metals and chemicals.

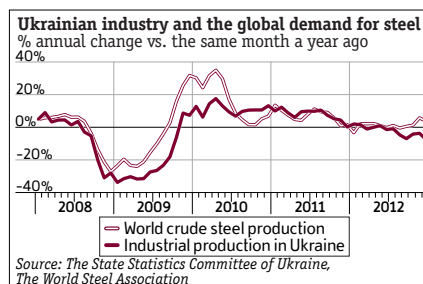
Lastly, buoyed by growing wages (inflation adjusted wages gained nearly 9% yoy in 2012) and more generous government spending on social welfare programs, Ukrainian consumers continued spending. Last year, retail sales jumped by 15.9% yoy - the strongest rebound of private consumption since the beginning of the economic recovery - while spending on food services saw a robust gain of 8.2% yoy. The performance of service providing sectors was mixed, with falling activity in freight and passenger transportation (down by 6.6% yoy and 1.2% yoy, respectively), although a lower volume of freight traffic can mostly be attributed to declining transit

	2012	2011	2010	2009
Agriculture	-4.5	17.5	-1.5	-1.8
Industrial output	-1.8	7.6	11.2	-21.9
Construction works	-13.8	11.1	-5.4	-48.2
Domestic trade turnover				
Wholesale trade	-4.4	0.6	0.4	-19.3
Retail trade	15.9	14.7	9.8	-17.4
Restaurants	8.2	11.0	3.5	-15.6
Transportation turnover				
Cargo	-6.6	5.7	6.4	-22.5
Passenger	-1.2	3.3	-0.2	-11.5
Services, non-financial	8.7	18.6	2.9	-16.8

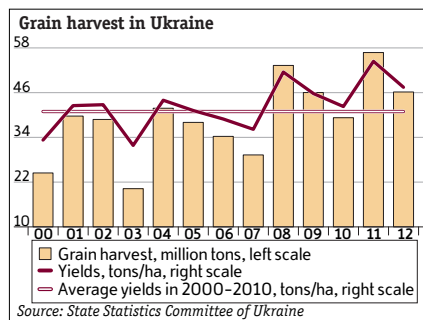
Source: State Statistics Committee



Source: State Statistics Committee of Ukraine



Source: The State Statistics Committee of Ukraine, The World Steel Association



Source: State Statistics Committee of Ukraine

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of natural gas; the overall demand for services, such as education and healthcare, remained fundamentally strong, as the volume of non-financial services grew by 8.7% yoy. This is important, because robust growth of domestic demand helped sustain business activity in the local services industry and, thus, partly offset output losses in the goods-producing sectors of the economy.

Fiscal Policy

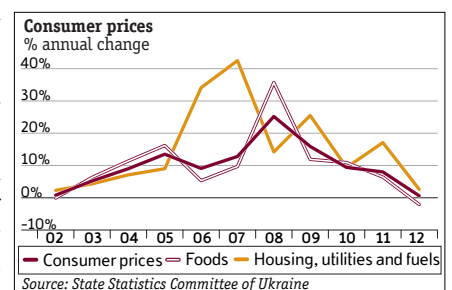
Growth of consolidated budget revenues and spending remained on divergent trajectories at the end of 2012. Proceeds from most taxes continued to decelerate, while the growth of budget spending stabilized and in January-November budget expenditure grew at the same pace as in the previous ten months. Consequently, the gap between the growth rates of spending and revenues continued to widen, which led to a larger budget deficit. Thus, in January-November, the consolidated budget revenues grew by 10% yoy versus 11% yoy in January-October. Spending, on the other hand, increased by 17% yoy during the first eleven months of 2012. These trends are markedly different from the fiscal development of 2011, when budget revenues recovered much faster while budget expenditures increased at a more conservative rate (up 27.4% yoy and 10.7% yoy, respectively). As a result, the consolidated budget deficit reached UAH 33.9 billion or about 2.4% of projected full year GDP, while the state budget deficit jumped to UAH 41.2 billion or 2.9% of projected full year GDP (excluding payments to cover the Naftogaz deficit, which may add another 2% to the 2012 budget deficit). In comparison, last year, the state budget deficit was only 1.7% of GDP in January-November.

Essentially, budget revenues continued to decelerate against the background of slowing economic activity. Indeed, though, tax collection continued to improve, revenues from main taxes grew at a slower rate versus a strong double-digit rebound in 2011. For instance, proceeds from the VAT registered the highest growth in January-November of 8.6% yoy while revenues from excises grew by 7% yoy and corporate income tax expanded by 2.1% yoy. As a result, the growth of tax revenues slowed below 10% yoy in January-November 2012 compared to a 60% yoy jump of tax proceeds during the same period a year ago. Booming domestic trade and growing imports helped lift VAT revenues at the end of 2012, partly offsetting weakening growth of proceeds from other taxes. However, recent trends in consolidated budget revenues still imply that slower economic growth is becoming a drag on the government's ability to collect more taxes.

In January-November, total cash expenditures of the consolidated general budget grew by 17.1% yoy versus more reserved growth of 9.6% yoy a year ago. Social assistance and social security expenditures (excluding expenditures to cover the Pension Fund deficit) slightly decelerated over January-November compared to January-October (from 28% yoy to 27.3% yoy) but still remained the main driver of general government expenditure growth. Yet, other big expenditure items saw an acceleration of growth. In particular, public spending on education increased by 17.9% yoy, while healthcare spending grew by 22.9% yoy. Meanwhile, at 10.7% yoy, the growth of spending on economic activity was twice as slow. All that said, as public spending continues to grow faster compared to tax revenues, the government will most likely experience intensified pressures to cut expenditures in 2012. After all, the persistence of this divergence may make it much harder to attract external funds to finance the budget deficit, and, in particular, to keep access to IMF loans. On that note, cooperation with the IMF is unlikely to resume unless the government commits to meaningful reform of energy subsidies to populations as a way to stabilize the fiscal situation in Ukraine.

Monetary Policy

Thanks to stable prices of foods, consumer prices barely changed in Ukraine in 2012. In fact, at 0.6% yoy (compared to 8% yoy in 2011), annual inflation posted its lowest reading in ten years. In particular, in December 2012, consumer prices were even a bit lower than a year ago – down by 0.2% yoy (versus an increase of 4.6% yoy in December 2011) as food prices dropped by 2.3% yoy (compared to an increase of 1.7% yoy a year ago). Relatively modest gains of fuel prices, which were up in December by only 6.9% yoy (set against an increase of over 30% yoy in December 2011), contributed to overall price stability as well. Lastly, utility tariffs, which grew by 11% yoy in December 2011, barely changed in 2012, increasing by only 0.5% yoy in December. However, a growing need to raise utility tariffs, which were frozen in 2012 (partly as a political consequence of the election cycle) to reduce budget spending, may emerge as a major driver of inflation this year. In addition, despite the current lull on international commodity markets, world prices of fuels and foods may start to grow as the global economic recovery gains traction. All of this points to elevated inflationary risk in 2013.



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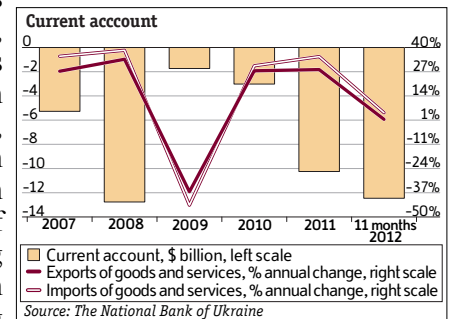
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Still, the monetary sources of inflation appear to be well contained, which will help mitigate the impact of possible supply tightening on world commodity markets on price stability in Ukraine. In particular, as banks continue to repay foreign loans (according to the National Bank of Ukraine, in 2012, the banking sector cut its foreign liabilities by another \$3 billion), they will struggle to fund new loans to businesses and consumers – in November, the stock loans issued to non-financial firms grew by just 6.4% yoy (versus 15% yoy a year ago), while credit to consumers dropped faster – by 7.6% yoy (compared to a more modest decline of 4.6% yoy in November 2011). True, local deposits continued to grow (in November, bank deposits by households and non-financial businesses were up by 18.2% yoy and 11.4% yoy, respectively), albeit at a somewhat slower pace compared to the initial phase of the economic recovery. However, although retail-deposits are more stable sources of bank funding, they may not offer the same flexibility as wholesale funding to finance a wider range of assets. As a result, the volume of bank lending inched up by less than 3% yoy or three times slower than in November 2011. Thus, the growth of money supply, as measured by monetary aggregate M3, slowed to 11.6% yoy in November compared to an increase of over 20% yoy at the end of 2011.

International Trade and Capital

Slowing global economic activity and, in particular, a recession in the Euro zone, was a major obstacle to Ukrainian exporters in 2012. Only one sector of the economy, which is agriculture, experienced significant growth in exports on booming overseas shipments of grains. Meanwhile, as economic problems in the EU deepened in the second half of 2012, Ukrainian exports of staple commodities, such as metals, started to fall. As a result, stalled recovery of global trade was the principle reason that weakness of the world economy transferred into national business activity. On the upside, imports grew somewhat slower than a year ago, especially at the end of 2012 on decelerating global energy prices, which may have curbed the widening of the trade in goods deficit. Still, the growth of imports exceeded the expansion of exports in 2012, leading to a higher foreign trade deficit and, thus, increasing external financing needs and less stability on the foreign exchange market.



Continuing recession in Europe forced Ukrainian producers to reorient their exports to other markets. In particular, the share of exports to Europe declined from 27.3% observed in January-November 2011 to 25% mainly due to a drop of exports to Italy by 20.3% yoy and declining exports to Poland – down by 6.4% yoy. At the same time, thanks to surging foreign demand for agricultural commodities, Ukraine increased its exports to Egypt by 2.3 times, to Kazakhstan by 42.3% yoy, and to Belarus by 15.1% yoy. On the other hand, the share of imports from Europe remained almost unchanged slightly above 32% of the total imports, while the share of imports from CIS countries declined by 4.1% in 2012 mainly due to a decrease in imports from Russia by 5.2% yoy (in particular, Ukraine decreased its imports of natural gas by around 2.5 bln cubic meters or \$1.2 bln).

Data of the State Statistics Service of Ukraine shows that Ukrainian exports of goods dropped 6.3% yoy to \$5.9 billion in November 2012. At the same time, imports saw an even bigger decline of 10.2% yoy to \$6.9 billion. This led to a narrowing of the trade in goods deficit by 27.9% yoy to \$1 billion. Having said that, despite a smaller monthly trade deficit at the end of 2012, from the beginning of the year, the foreign trade gap grew by 7.7% yoy to \$13.8 billion (or over 7% of projected full year GDP) as imports increased faster than exports at 2.9% yoy versus 1.9% yoy. Growth rates of both exports and imports are much slower than those observed in 2011 (34.3% yoy and 38.1% yoy, respectively). Total exports reached \$63.1 billion over January-November 2012, while total imports stayed at \$76.9 billion.

Ukrainian agriculture once again proved its high export potential as it managed to increase exports of goods in all its branches in 2012. The major driver of growth in agriculture was again grain production, as its exports grew by 101.4% yoy to \$6.2 billion over January-November 2012 (or about one tenth of all exports). Total exports of the plant cultivation sector grew by 71.7% yoy to \$8.2 billion while imports of the sector grew by 34% yoy to \$2.1 billion. Grain farming aside, other sectors of agriculture continued to lag in terms of expanding their export potential. For example, animal agriculture was much less successful in terms of foreign trade compared to plant cultivation during the reporting period, as growth of its imports significantly exceeded growth of exports (69.4% yoy versus 4.8% yoy).

Contrary to agriculture, other traditional drivers of Ukrainian exports, like chemicals and metallurgy, weakened in January-November 2012. For example, exports of chemical products declined by 3.8% yoy, while imports grew by 6.7% yoy. As a result, the trade deficit in chemicals reached \$3 billion, which is 28.8% higher than during the same period of 2011.

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Exports of nonferrous metals, in turn, declined by 13% yoy to \$17.6 billion compared to a 28.1% yoy rebound last year. Imports also declined but at a slower pace – by 7.4% yoy to \$4.8 billion. As a result, Ukraine generated a \$12.2 billion surplus of foreign trade in nonferrous metals, which is still lower than \$15 billion during the same period of the previous year.

The largest foreign trade deficit was, naturally, generated by the trade in mineral products. There are two reasons for this – a natural decline in demand for mineral products during economic instability and high imports of natural gas. Exports in the sector dropped 25% yoy over January-November 2012, while imports declined by 7.8% yoy. Therefore, the foreign trade deficit in mineral products reached \$25.3 billion compared to \$18 billion in January-November 2011. Excluding imports of natural gas, the deficit of trade in mineral products was \$12.4 billion or 136.4% yoy higher.

A slower growth of exports compared to that of imports continued to widen the current account gap. According to preliminary data of the National Bank of Ukraine, the current account deficit for January-November 2012 reached \$12.5 billion (or about 7% of projected full year GDP), which is 38.1% higher than a year ago. Thanks to \$685 million net FDI inflow in November, Ukraine received almost the same amount of FDI in the first eleven months of 2012 as a year ago despite less favorable global investor sentiment and higher political uncertainty in the second half of 2012. These FDI inflows, however, were not enough to cover the external funding needs of Ukraine, which were higher in 2012 due to the repayment of IMF loans (the government and the central bank paid back \$3.4 billion to the IMF in 2012). As a result, last year, the foreign exchange reserves of the National Bank declined by \$7.6 billion to \$24.5 billion at the beginning of 2013.

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