

May 2013

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- Real GDP declined by 1.1% yoy in 1Q 2013 amid feeble external demand and investment activity.
- The decline in industrial production moderated to 2.2% yoy in April, confirming that the Ukrainian economy has been gradually strengthening.
- Private consumption continued growing at a robust pace, fueled by strong real wage growth and benefiting domestic demand driven sectors.
- Public finances remained under strain amid falling budget revenues and increasing social expenditures. But thanks to solid domestic and external borrowings, the overall fiscal situation remained manageable.
- Annual inflation stayed at -0.8% in April, unchanged from March.
- Banking sector resource base continued to improve, supported by strong deposit growth and growing money supply. However, credit growth remained anemic.
- Ukraine's current account gap narrowed in April thanks to resumed export growth and an ongoing decline in energy imports. The country also enjoyed robust foreign capital inflows, which helped slightly replenish gross international reserves.
- Balance of Payments improvement and favorable purchasing power parity estimates point to diminished Hryvnia exchange rate depreciation pressures.

Executive Summary

The fragile external environment and weak bank lending activity continued to be a drag on economic growth in Ukraine. Weakness in external demand, feeble industrial production and March's bad weather conditions drove a decline in GDP by 1.1% yoy in 1Q 2013. Quarterly data and soft business sentiment indicators, however, suggest that economic activity may have already bottomed out and a recovery to growth may be expected in the second half of 2013.

Real sector data for April confirmed that the Ukrainian economy has been gradually strengthening. The decline in industrial production moderated to 2.2% yoy in April amid eased rates of contraction in metallurgy, manufacturing of transport vehicles and chemicals. Moreover, pharmaceuticals, food manufacturing and agriculture demonstrated solid growth rates. In addition, thanks to improvements in the industrial sector, the decrease in wholesale trade turnover slowed to 4.2% yoy over January-April 2013. However, a more modest and slower than expected improvement in the EU economy, in addition to a constrained domestic credit supply, led us to revise our real GDP growth forecast for Ukraine downwards to 1% yoy in 2013.

Despite signs of improving economic performance, Ukraine's fiscal challenges seem to be mounting. State budget revenues fell by 6.5% yoy in nominal terms in April, while expenditures increased by almost 18% yoy, causing a sharp widening in the budget deficit. The cumulative deficit was almost four times higher than in January-April of last year. At the same time, the fiscal situation remains manageable thanks to solid domestic and external borrowing. However, comprehensive consolidation measures are necessary to sustain public finances in the longer term.

Consumer inflation remained low in Ukraine in March

and April 2013. Annual inflation stayed at -0.8% in April, unchanged from March, reflecting declining fuel prices, mostly flat utility tariffs and falling food prices. Furthermore, the monetary impact on inflation remained subdued despite an observed acceleration in money supply growth over the last few months. Given current price developments, good prospects for the agricultural harvest and government efforts to find ways to avoid a painful adjustment to the natural gas tariff adjustment for the population, consumer price growth should be contained at around 4% yoy at the end of the year.

Following some deterioration in March 2013, Ukraine's current account gap narrowed in April. In March 2013, exports fell by almost 10% yoy, affected by weather-related transportation disruptions and Russia's new trade restrictions. In April, however, exports resumed growth amid higher shipments of mineral and chemical products. In contrast, imports declined in both March and April, affected by government efforts to reduce energy imports. In addition, Ukraine continued to enjoy robust foreign capital inflows, benefiting from loose international liquidity and revival of foreign investors' risk appetite and likely larger repatriation of Ukrainian funds from offshore centers due to recently increased safety concerns. These funds were sufficient to cover Ukraine's foreign financing needs and slightly replenish its gross international reserves to \$25.2 billion at the end of April.

Lower inflation dynamics in Ukraine since 2010 (compared to its main trading partners) have made purchasing parity estimates quite favorable for the country. Coupled with Balance of Payments improvement, this points to a diminished need for exchange rate adjustment. As a result, we believe the NBU will continue to target Hryvnia exchange rate stability over the next few years, allowing a maximum depreciation of about 5%.

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	2009	2010	2011	2012 ^a	2013 ^b	2014 ^b
GDP growth, % yoy	-14.8	4.1	5.2	0.2	1.0	3.5
GDP per capita, \$	2 545	2 974	3 575	3 864	4 160	4 487
Industrial production, % yoy	-21.9	11.2	7.6	-1.8	0.5	3.0
Retail sales, % yoy	-16.6	9.8	14.8	15.9	-	-
Budget deficit, % GDP ^c	-8.9	-7.0	-4.3	-5.6	-4.0	-3.0
Government external debt, % GDP	20.5	23.8	20.4	18.5	18.5	18.5
Inflation, eop	12.3	9.1	4.6	-0.2	4.0	5.0
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	-8.2	-7.0	-6.5
Gross external debt, % GDP	88.2	86.0	77.2	76.6	74.7	72.6

^aIncluding Naftogaz and Pension fund deficits (not including bank recapitalization expenditures and VAT refund bonds in 2009 and 2010 respectively).
^bSource: State Statistics Committee of Ukraine, NBU, Ministry of Finance of Ukraine, 2013 Budget Law, The Bleyzer Foundation
^cSource: State Statistics Committee of Ukraine, NBU, Ministry of Finance of Ukraine, 2013 Budget Law, The Bleyzer Foundation

Economic Growth

The fragile external environment and weak bank lending activity continued to be a drag on economic growth in Ukraine. In March 2013, the impact of these factors was amplified by adverse weather conditions. Indeed, heavy snow during the month caused disruptions in supply chains, affecting manufacturing, transportation, and exports. The decline in manufacturing deepened to 9.3% yoy in March 2013, led by machine building, metallurgy, chemicals, and oil-refining. The real value of cargo transportation and wholesale trade turnover edged down by 9.3% yoy and 5.4% yoy, respectively, over January-March 2013. The construction sector suffered particularly from cold and snowy weather with the real value of construction works down by almost 14% yoy in 1Q 2013.

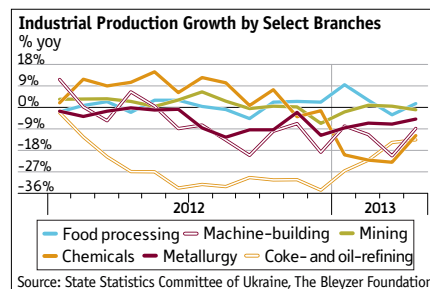
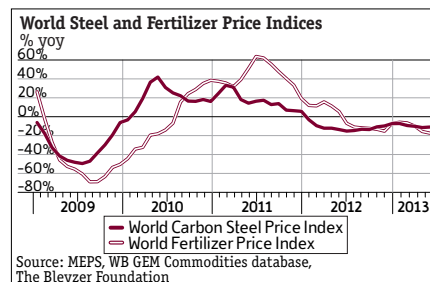
The weakness in external demand, feeble industrial production and March's bad weather conditions drove a decline in GDP by 1.1% yoy in 1Q 2013. Quarterly data, however, suggests that economic activity may have already bottomed out. Contraction in economic activity slowed compared to the last quarter of 2012. Moreover, the NBU survey indicators of business expectations continued to improve in 1Q 2013, showing that stabilization took place in 1Q 2013 and a recovery to growth may be expected in the second half of 2013.

Real sector data for April confirmed that the Ukrainian economy has been gradually strengthening. Indeed, the decline in industrial production moderated to 2.2% yoy in April amid eased rates of contraction in metallurgy, manufacturing of transport vehicles and chemicals (including production of fertilizers) to less than 5% yoy, 20% yoy and 12% yoy respectively. As world steel prices continued to trend downwards, the improvement in metallurgy may be attributed to the resumption of operations by two ferroalloy producers, which suspended work in December 2012 amid rising electricity prices and buoyant imports.¹ Better results in the domestic car manufacturing industry were caused by the imposition of a special duty on imported cars in mid-April.² Although both measures (protectionist import duty and producers' tariff prices) may stimulate domestic production in the short-run, they may not outweigh output and welfare losses in the long run, as they will dampen investments in modernization, innovation, and quality improvement.

Production of pharmaceutical and food products, as well as agricultural goods, remained on the rise. A 27% yoy increase in medical drug manufacturing over the first four months of 2013 may be the result of harmonization of Ukraine's legislation with EU requirements on compulsory licensing of pharmaceutical patents and introduction of licensing for imported drugs. According to estimates, the share of imported drugs accounts for about 80% of the Ukrainian retail pharmaceutical

	2013		2012	2011	2010
	4m	3m			
Agriculture	5.1	5.8	-4.5	17.5	-1.5
Industrial output	-4.2	-5.0	-1.8	7.6	11.2
Construction works	-16.2	-13.9	-13.8	11.1	-5.4
Domestic trade turnover					
Wholesale trade	-4.2	-5.4	-4.4	0.6	0.4
Retail trade	12.7	13.4	15.9	14.7	9.8
Transportation turnover					
Cargo	-10.7	-9.3	-7.6	5.7	6.4
Passenger	-3.4	-3.5	-1.2	3.3	-0.2
Communication services	2.0	1.2	1.1	3.1	
Services, non-financial	0.2	2.9	0.8	18.6	2.9

Revised data
Source: State Statistics Committee



¹During February 2013, the plants' owners and the government of Ukraine agreed on electricity tariff prices for the plants, which will be in effect up to the end of 2013.

²An import duty of 6.46% and 12.95% on top of a regular 10% was imposed on cars with an engine size ranging from 1000 to 1500 cm³ and 1500 to 2200 cm³ respectively. The duty will stay in effect for three years.

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market. Although Ukraine has its own drug manufacturers, they mostly concentrate on production of lower-priced generics and vitamins.³ Approval of the compulsory licensing legislation will allow for production of more affordable medicines that still have unexpired patents.

Manufacturing of foodstuffs rose by 1.6% yoy in April, supported by a solid increase in agriculture and buoyant consumption. Indeed, agricultural output was up by 5.1% yoy over January-April 2013, while retail sales, often used to gauge the consumption growth pattern, expanded by 12.7% yoy over the period, underpinned by a 10.2% yoy real wage growth. Thanks to improvements in industrial production, the decrease in wholesale trade turnover slowed to 4.2% yoy over January-April 2013.

Although there were clear signs of easing downturn of the Ukrainian economy, more modest and slower than expected improvements in the EU economy and constrained domestic credit supply led us to revise the real GDP growth forecast for Ukraine downwards to 1% yoy in 2013. The positive momentum in private consumption is forecast to be the main driver of economic growth in 2013 and 2014. Consumer spending will be sustained by diminished inflation expectations and a more stable exchange rate. Although budget spending is forecast to grow at a more reserved pace, fiscal consolidation is likely to exert a greater toll on government consumption and investment rather than expenditures on the public wage bill, social welfare and protection. A gradual strengthening of the external environment of Ukraine's main trading partners and entering a Free Trade Agreement with the EU should support Ukraine's exports in 2014. In addition, solid improvements in agricultural production over the last few years and growing investment in the agricultural sector may signal that Ukraine has been gradually unlocking its high agricultural potential. As a result, agriculture may be a strong driver of both production and export growth over the medium-term, though its impact may fluctuate depending on weather conditions. In turn, imports are forecast to be contained by government efforts to reduce the volume of energy imports, the weightiest commodity group in total imports. All in all, the Ukrainian economy is forecast to pick up by about 3-4% yoy in 2014 and should be able to grow by about 4-5% per annum over the medium-term.

Fiscal Policy

Despite signs of improving economic performance, Ukraine's fiscal challenges seem to be mounting. State budget revenues fell by 6.5% yoy in nominal terms in April, while expenditures rallied at almost 18% yoy. As a result, the state budget deficit widened sharply that month, while the cumulative deficit was almost four times higher than in January-April of 2012.

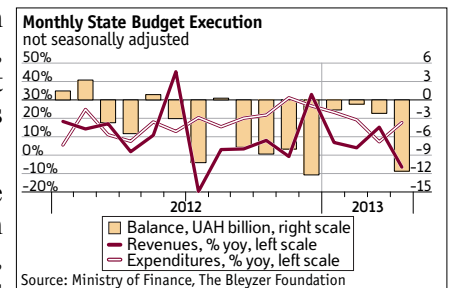
April's fiscal developments were additional evidence that government revenue requirements are unlikely to be met this year. Lower than forecast economic growth and inflation weighed on budget revenues. Thus, despite booming consumption, VAT collections were only 0.3% yoy higher in January-April of this year. Proceeds from import taxes reported a moderate 7.3% yoy growth over the first four months of the year as weak investment demand and government efforts to reduce energy imports outweighed the increase in import duties. April is a seasonally weak period for corporate profit tax collections. In addition, a 2 percentage point reduction in the corporate profit tax rate to 19% was enforced at the beginning of the month. As Ukrainian enterprises pay profit tax in advance⁴, the decline in the tax rate was felt in April. Receipts from the corporate profit tax were only 2.5% yoy higher that month compared to a 28.5% yoy increase over 1Q 2013.

On the expenditure side, social security and public debt-related spending were the main drivers of state budget expenditure growth over the first four months of the year. In particular, social security and protection outlays rose by 42% yoy, while public debt service payments were up by almost 30% yoy over January-April. Although these spending increases were partly offset by expenditure savings on public investment and other discretionary spending, budget outlays grew much faster than receipts.

Despite growing fiscal pressures, however, the fiscal situation remained manageable thanks to solid domestic and external borrowings. Taking advantage of loose international liquidity and a revival of investors' risk appetite, Ukraine issued \$1.25 billion 10-year Eurobonds in mid-April at a 7.5% coupon rate, 12.5 basis points and 30 basis points lower than the yield rates of the February 2013 and November 2012 Eurobond placements, respectively. Moreover, benefiting from improved

³Source: The Parliamentary hearings 'On the current state and prospects of the pharmaceutical industry of Ukraine', June 15, 2011.

⁴Since the beginning of 2013, corporate profit tax is paid according to the following method: 1/9 of the profit tax accrued for the first nine months of the previous year in January and February and 1/12 of the profit tax of the previous year from March to December.



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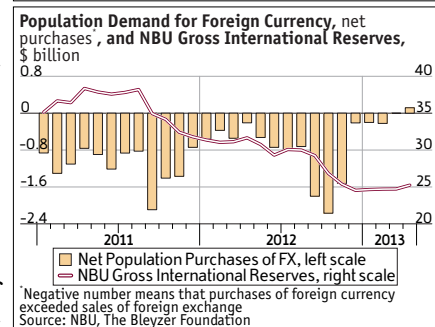
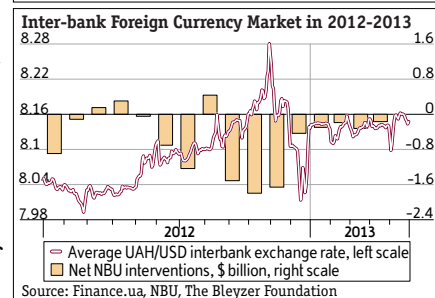
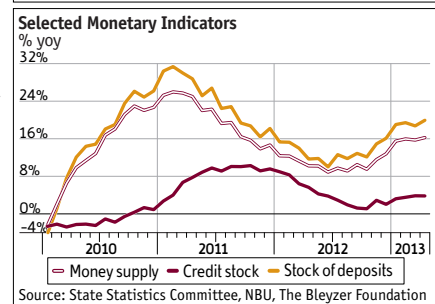
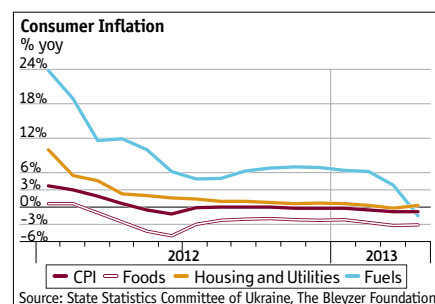
banking sector liquidity and diminished Hryvnia depreciation pressures, Ukrainian authorities were very active in attracting funds in national and foreign currency on the domestic debt market. Over the first four months of 2013, Ukraine issued UAH 16.1 billion (around \$2 billion) of Hryvnia-denominated and \$2.4 billion of USD-denominated domestic bonds. The attracted funds were sufficient to cover the widening fiscal deficit and to meet Ukraine's foreign public debt liabilities, even in the absence of IMF financing. However, despite favorable current picture, further consolidation measures are necessary to sustain public finances. Government officials have already announced that they've been developing budget revision proposals. Although the details were not available, we believe a mix of revenue increases (e.g., by further raising excise taxes) and spending cuts will be proposed, which would help narrow the general public sector deficit to around 4% of GDP in 2013.

Monetary Policy

Consumer inflation remained low in Ukraine in March and April 2013. Annual inflation stayed at -0.8% in April, unchanged from March, reflecting declining fuel prices, mostly flat utility tariffs and falling food prices, which offset higher prices on alcohol and tobacco, communication and other services. In addition, clothing and footwear prices were down by 2.7% yoy, and furniture and household equipment by 0.2% yoy in April. Due to a high share of imported goods, the price decrease in these commodity groups may be attributed to diminished Hryvnia depreciation pressures. Furthermore, the monetary impact on inflation remained subdued, despite the observed speed-up in money supply growth over the last few months. Inflation is forecast to slightly accelerate in 2H 2013 amid a fading favorable base effect and eventual adjustment of utility tariffs. However, the government has been actively seeking ways to sustain Naftogaz financing without a painful adjustment to natural gas tariffs for the population. As a result, the tariff increase may be rather gradual or may apply to only select households. Hence, given current price developments and likely moderate tariff adjustment, consumer price growth is expected to be contained at around 4% yoy at the end of the year.

Money supply growth continued to gain momentum in March and April. An almost 17% yoy increase in M3 monetary aggregate in April 2013 was the result of acceleration in monetary base growth and a buoyant increase in deposits. Thus, annual growth of the monetary base increased to 12.8% yoy in April, up from about 10% yoy in March. The speed-up mainly reflected improvements in banking sector liquidity, underpinned by lower NBU sterilization operations and greater refinancing activity. Although government cash balanced with the NBU rose in March and April, the impact of their increase was outweighed by large NBU purchases of government securities. The NBU remained the principal buyer of government bonds over the first four months of 2013; its portfolio of government bonds grew by 19% over the period. As a result, the share of government securities held by the National Bank of Ukraine exceeded 58% at the end of April 2013.

The volume of deposits in the Ukrainian banking system kept growing, adding almost 20% in April on an annual basis. Corporate deposits gained 22.8% yoy over the period, which may be an additional signal of reviving economic activity and the improving financial stance of Ukrainian enterprises. At the same time, it may also point to subdued investment activity, as money is deposited in commercial banks rather than invested. Household deposits rose by 18.5% yoy in April, underpinned by robust real wage growth, attractive deposit rates and diminished Hryvnia depreciation pressures. Despite improved banking sector liquidity and low inflation, interest rates on deposits have reported moderate declines since the beginning of the year, as household deposits are among the most important source of funding for Ukrainian banks. On the downside, however, high deposit rates and credit risk are keeping lending rates high, adversely affecting demand for loans. Hence, despite a strengthening deposit base and improved banking sector liquidity, lending to the private sector remains weak. The stock of loans rose by less than 4% yoy as of the end of April.



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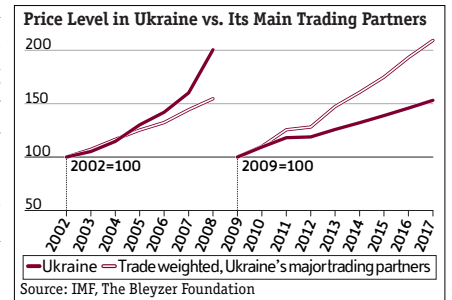
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Faster growth in monetary aggregates may also be related to a stable foreign exchange market. Targeting exchange rate stability, Ukrainian monetary authorities usually tighten money supply to contain depreciation pressures. Since the beginning of 2013, the Hryvnia exchange rate has been fluctuating within a relatively narrow margin of UAH 8.10-8.16 per USD, which allowed for some easing of monetary conditions in an attempt to stimulate credit growth. At the same time, despite the recent acceleration, money supply growth still compares favorably to the over 40% increase before 2008. We believe the monetary impact on inflation will remain subdued over 2013-14.

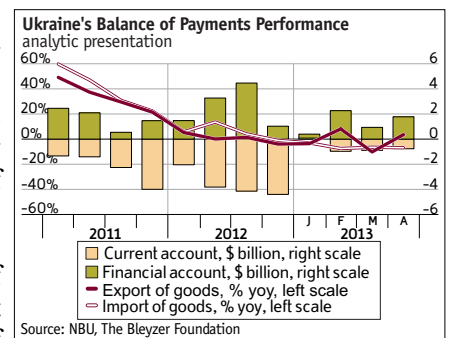


Relative Hryvnia exchange rate stability was achieved thanks to continued NBU support of the Hryvnia exchange rate, though much less sizable than in the fall of last year, and weakening population demand for foreign exchange. The latter was a considerable drag on both the capital account of Ukraine's Balance of Payments and the Hryvnia exchange rate over the last few years. Amid an improving macroeconomic environment and strengthening consumer confidence, population purchases of foreign currency exceeded sales by only \$2.7 million in March, while in April the population bought less foreign currency than it sold, for the first time in four years.

Ukraine's purchasing power parity estimates also point to diminished Hryvnia depreciation pressures. Due to subdued price growth since 2010, inflation in Ukraine was and is forecast to stay lower than in its main trading partners. This signals that the country has restored its international competitiveness lost during the high inflation pre-crisis years. Given these favorable estimates as well as good prospects for Balance of Payments improvement, we believe the NBU will continue maintaining the Hryvnia exchange rate peg to the US Dollar over the next few years, by allowing a marginal devaluation of about 5%.

International Trade and Capital

Following some deterioration in March 2013, Ukraine's current account gap narrowed in April. In March 2013, exports fell by almost 10% yoy, affected by weather-related transportation disruptions and Russia's new trade restrictions. As these causes proved to be short-lived, Ukraine's merchandise exports reported a 3% yoy increase in April. Thus, exports of machinery and transport vehicles grew by 2.7% yoy in April, compared to a 16% yoy reduction in March. Almost 70% of this commodity group's exports are destined for Russia and other CIS countries, which makes it vulnerable to trade relations with these countries. Indeed, Russia's suspension of the quality production certificate for a major Ukrainian producer of railcar castings⁵ weighed on rail machinery production and exports during the first four months of 2013. Although the certificate was reinstated at the beginning of April, output limits were imposed. Additionally, given slowing economic growth in Russia, the rate of expansion of this commodity group's exports is likely to remain subdued.



Economic weaknesses in the EU, one of the key overseas markets for Ukraine, and ongoing downward trend of world steel prices, weighed on exports of metallurgical products, which decreased by about 6.5% yoy in March and April. In addition, exports of agricultural and food products were almost 10% lower in March-April 2013, compared to the corresponding period last year. A high base effect and wheat export restrictions imposed at the end of last year were the main reason for the decline. Indeed, the government and grain traders agreed to ban grain exports following their rapid growth amid a moderate harvest in 2012. As the ban was lifted at the end of April, agricultural exports may improve in the coming months.

On the upside, Ukraine's exports of mineral products rose by 47% yoy in April, mainly on account of higher shipments of iron ores. Strong foreign demand for iron ores and international supply disruptions due to adverse weather conditions in Australia and export restrictions in India helped drive Ukraine's exports. In addition, exports of chemical products (fertilizers in particular) grew by 13% yoy in April.

In contrast to exports, imports kept declining in March and April. A 6.4% yoy and an almost 8% yoy reduction in imports over these two months, respectively, was mainly the result of government efforts to reduce energy imports. Indeed, foreign

⁵Kremenchug Steel Casting Plant is one of the main suppliers of castings for freight wagon producers in Ukraine and Russia.

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supplies of mineral goods to Ukraine went down by 14% yoy in March and 30% yoy in April. The Ukrainian authorities have been taking steps to reduce energy imports by diversifying natural gas supplies, substituting imports with domestic fossil fuels and stimulating energy savings.

As export performance improved while imports continued to decline, Ukraine's current account gap in April was almost 30% lower than last year, while the first four months deficit stood at \$2.4 billion, about \$0.6 billion lower than in the corresponding period of 2012. Moreover, Ukraine has been generating solid capital account surpluses this year, benefiting from loose international liquidity, revival of foreign investors' risk appetite and likely larger repatriation of Ukrainian funds from offshore due to recently increased safety concerns. The inflows of foreign capital helped cover Ukraine's current account deficit, meet its foreign debt liabilities and slightly replenish its gross international reserves. The latter grew by 2.1% mom to \$25.2 billion at the end of April. Although the reserves stayed slightly below three months of imports, the overall Balance of Payments trends this year look encouraging, supporting our view of diminished pressures for exchange rate adjustment.

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