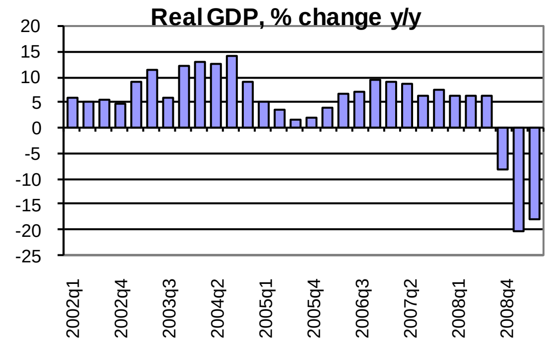
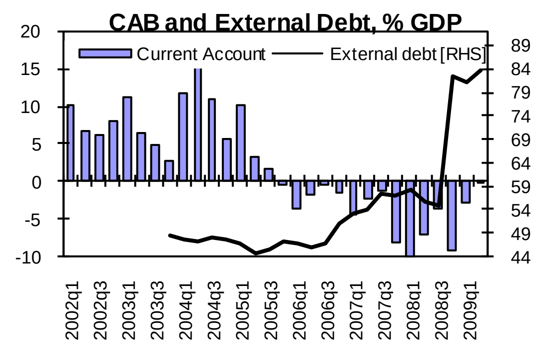
THE WORLD BANK

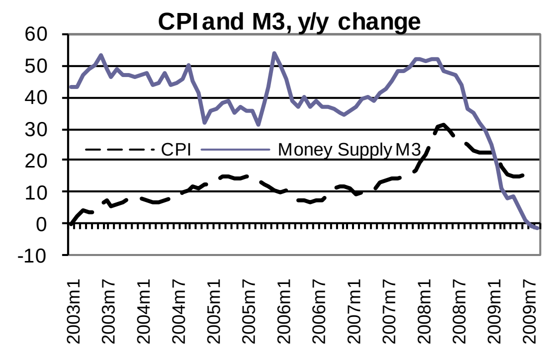
UKRAINE Economic Update

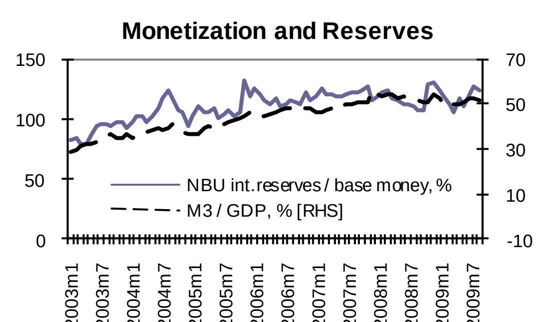
October 15, 2009

- ***Ukraine's real sector bottomed out in the first half of 2009, but fiscal and financial pressures give no ground for complacency.***
- ***Reflecting the global outlook we improved our growth forecast for 2010 but domestic demand is likely to remain subdued.***
- ***Credible fiscal policy and structural reforms are crucial to renew investors' confidence and enable a sustained recovery. Of immediate concern is the approval of a prudent and financeable 2010 budget.***









Recent Economic Developments

Recent data indicate that the real sector bottomed out in the first half of 2009. Real GDP dropped by 17.8 percent in 2009Q2 y/y after a 20.3 percent decline in 2009Q1. The pace of decline in private consumption was broadly unchanged at 11.6 percent y/y, while fixed investments sunk further by – 57.8 percent y/y. The contribution of net exports to growth became larger as real imports declined faster (-53.5% y/y) than exports (-32.3% y/y). Output indicators point to stronger performance in Q3. In particular, industrial production started to recover gradually in recent months: after a -31% y/y in H1 it dropped by 27% in July and by 23% in August.

While the current account has adjusted, net capital outflows remain a source of balance of payment pressures. In the first 8 months of 2009, the CA deficit amounted to USD 1.1 billion, USD 7 billion lower than a year ago. At the same time, external debt roll-over for banks and corporates was 76%, resulting in USD 7.1 billion net outflow over the period. Additionally, 'domestic capital outflows' – flight to foreign cash by residents – drained out USD 5.7 billion. The recent IMF's SDR quota allocation and the SBA have helped to ease what otherwise would have been a major drop of forex reserves. The marginal weakening of the external accounts over the summer, higher demand for forex from corporates and households, on the back of heightened depreciation expectations have placed pressure on the currency since end-July. The depreciation trend also resulted in the leakage of Hryvnia deposits from the banking sector by 7% during Q3. Multiple exchange rates reappeared as a result of selective NBU interventions.

With the drop of tax revenues becoming more acute, the fiscal deficit remains a key concern for macroeconomic stability. Over 8 months of 2009, consolidated budget revenues declined by 8.5% y/y in nominal terms, while budget expenditures increased by 7,5%. Additionally, the financing of the structural gap of Naftogaz due to under-pricing remains unsolved.

Medium Term Outlook

We keep our earlier forecast of Ukraine's GDP in 2009, but improve the outlook for 2010 in line with better than expected external market conditions. A 15 percent GDP contraction in 2009 remains consistent with the economic dynamics to date and with an expected improvement in headline numbers during the remainder of the year. For 2010, we expect growth of 2.5% in line with improved export demand prospects, although we forecast only a moderate revival for Ukraine. While the stress in global financing conditions is easing, Ukrainian commercial banks continue to face increasing NPLs which will drag down lending, including for working capital, and thus slow the pace of recovery. Strained private sector finances will constrain investment, while continued labor market adjustment and cost cutting strategies in the corporate sector will weigh down on consumption demand. We expect inflation to fall to below 14% by end-2009 and to below 11% by end-2010. An even faster reduction of inflation would be consistent with Ukraine's current output gap, but the delayed adjustment of energy and utilities tariffs will prolong the process of disinflation. The current account would need to be close to zero in 2009-2010 and the IMF SBA to be on track to assure a stable balance of payments situation and an adequate foreign exchange reserves position, and thus downside risks to our forecast remain serious.

Investors' confidence, macro stability, and a sustained recovery will rely heavily on prudent fiscal policy in the rest of 2009 and 2010, as well as on key structural reforms (linked to public finances). Our review of the 2010 draft budget suggests that the target deficit of 4 percent of GDP is unachievable without significant further spending reductions. We believe revenue projections face downside risks, in part due to overly optimistic macroeconomic parameters, while expenditures, particularly on pension payments, may have been underestimated. According to our estimates without further changes, the overall deficit could exceed 8 percent of GDP. In addition, if gas and heating tariff increases are not implemented in 2009 and in the first half of 2010, Naftogaz would face additional financing needs. Our forecast assumes that the draft budget will incorporate revisions to bring the deficit in line with the 4 percent target agreed with the IMF during the 2nd review, which would ensure consistency with current constraints on non-inflationary sources of financing and medium-term debt sustainability. Finally, the 2010 budget would benefit from provisions to improve the targeting of social safety nets to protect the most vulnerable households. Some key structural reforms (closely linked to public finances) such as the public procurement law and reforms in the gas sector would further reinforce signals that the country is open for business and willing to improve transparency and thus help attract much needed private investment to fuel the recovery.

Table 1: Key Macroeconomic Indicators

	2004	2005	2006	2007	2008	2009F	2010F	2011F
Nominal GDP, *UAH billion*	345.1	441.5	544.1	720.7	949.9	912.3	1032.4	1169.0
Real GDP, *% change*	12.1	2.7	7.3	7.9	2.1	-15.0	2.5	3.5
Consumption, *% change*	9.7	15.7	12.4	13.6	9.0	-15.9	2.4	4.6
Fixed Investment, *% change*	20.5	3.9	21.2	23.9	1.6	-53.6	6.1	8.0
Export, *% change*	21.3	-12.2	-5.6	3.3	5.2	-18.4	2.8	2.5
Import, *% change*	15.5	6.4	6.8	21.5	17.1	-35.3	1.9	6.1
GDP deflator, *% change*	15.2	24.6	14.8	22.7	29.2	13.0	10.4	9.4
CPI, *% change eop*	12.3	10.3	11.6	16.6	22.3	13.8	10.6	9.3
Current Account Balance, *% GDP*	10.6	2.9	-1.5	-3.7	-7.2	-0.6	0.1	-2.1
Terms of Trade, *% change*	3.5	8.3	4.9	9.8	6.1	-8.0	0.4	0.3
Budget revenues, *% GDP*	37.1	41.8	43.7	42.3	43.9	40.6	41.7	42.2
Budget expenditures, *% GDP*	41.5	44.1	45.1	44.3	47.0	47.6	45.7	44.6
Fiscal balance (w/o bank recap), *% GDP*	-4.4	-2.3	-1.3	-2.0	-3.1	-7.0	-4.0	-2.4
External debt, *% GDP*	47.1	45.3	50.4	58.6	83.6	92.6	82.4	72.0
Public and Guaranteed Debt, *% GDP*	24.7	17.7	14.8	12.4	20.1	36.7	41.7	40.7

Source: Ukrainian Authorities, WB projections

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