



INSTITUTE FOR ECONOMIC RESEARCH AND POLICY CONSULTING

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Macroeconomic Forecast Ukraine – quarterly issue

Recovery will be slow

EXECUTIVE SUMMARY

GDP: The Institute downgraded the forecast of real GDP development. The real GDP is forecasted to contract by 15.0% in 2009. It will grow by 3.4% in 2010.

Disposable Incomes and Unemployment: Households' real disposable incomes will decline by 10.9% in 2009 and increase by 1.0% next year. Unemployment rate (ILO methodology) will reach 9.5% of economically active individuals between 15 and 70 years old in 2009, and decline to 8.8% in 2010.

Fiscal Indicators: The fiscal deficit is estimated at 5.4% of GDP in 2009, not taking into account funds required for banks' recapitalization. Fiscal risks remain substantial.

Balance of Payments: The current account will be in deficit at 1.0% of GDP in 2009 and at 1.1% of GDP in 2010. The large net outflows of other investments will result in financial account deficits in 2009 and 2010.

Monetary Survey: Money supply in 2009 will decline by 5.6%, but rapidly increase in 2010. The official exchange rate will be on average at UAH/USD 7.83 in 2009, and UAH/USD 8.17 in 2010. The consumer price inflation is expected to remain high.

Pessimistic Scenario: Later than assumed recovery of global economy and increased political pressure remain the major risks for economic development in Ukraine. Under pessimistic scenario the real GDP will drop by 16.2% in 2009 and further decline by 0.2% in 2010.

Optimistic Scenario: In case of faster recovery of the economic activity in Ukraine the real GDP is expected to decline by 13.4% in 2009 and grow by 5.2% in 2010.

Key forecast figures for baseline scenario

	2005	2006	2007	2008	2009E	2010F
Real GDP, % yoy	2.7	7.3	7.6	2.1	-15.0 ↓	3.4 ↓
Consolidated fiscal revenues, UAH bn	134	172	220	298	265 ↓	309 ↓
Consolidated fiscal balance % of GDP	-1.8	-0.7	-1.1	-1.5	-5.4 ↑	-3.8 ↓
Current account balance, % of GDP	2.9	-1.5	-4.2	-7.2	-1.0 ↑	-1.1 ↓
Net FDI inflow, USD bn	7.5	5.7	9.2	9.7	5.0	6.0 ↓
Money supply, UAH bn	193	259	391	513	484 ↓	573 ↑
CPI, % aop	13.5	8.0	12.8	25.2	15.4 ↓	12.9 ↓

Note: E - estimate, F - forecast, yoy - year-on-year change, aop - average of the period, ↓ - if forecast was revised downwards, ↑ - if forecast was revised upwards

Source: State Statistics Committee, NBU, State Treasury, IER forecasts and estimates

Date of forecast completion: October 28, 2009

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GROSS DOMESTIC PRODUCT

GDP: The real GDP will grow by 3.4% in 2010

According to the Derzhkomstat the real GDP in the second quarter of 2009 contracted by 17.8% yoy, which is worse than the figure embedded in the forecast. While the consumption decline was lower than estimated, the investments dropped more substantially. External trade developments were in line with expectations and assumptions. On the production side, economic performance in sectors like industry, trade and transport was somewhat better than we expected, but other sectors including education and health deteriorated more. As a result, we downgraded the real GDP contraction in 2009 to 15.0%. Some rebound will be observed in 2010 with the real GDP growth at 3.4%.

In the second half of 2009 the real final consumption of households will continue dropping at the similar pace as in the first six months of the year as higher net repayments of credits will counterweight increase in nominal incomes in the second half of 2008. Real investments will perform somewhat better than in the first half of the year. The real exports decline will remain at similar levels, while real imports contraction will decelerate primarily because of statistical base effect.

Slow recovery of Ukraine's major trade partners remains one of the largest risks for Ukraine's economic performance in the last quarter of 2009. In addition, increasing political instability becomes a substantial risk. The IMF refusal to grant the country another tranche under the Stand-By arrangement would negatively affect the expectations of investors.

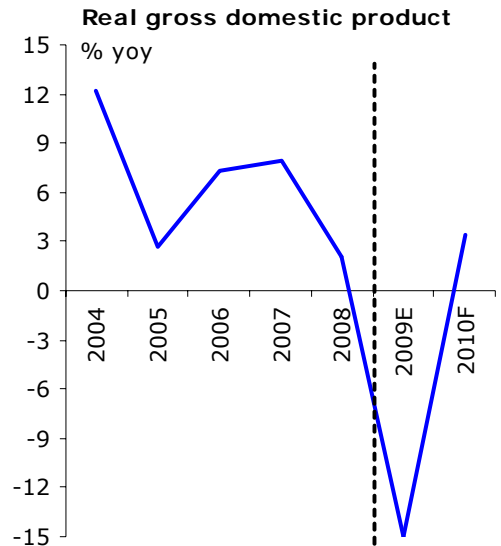
Economic perspectives of Ukraine look better for 2010 thanks to expected gradual recovery of the world economy. However, the external demand for Ukrainian goods will grow slowly. Slow renewal of lending should support private investments and consumption. The state investments into infrastructure projects will increase, though still remain low.

In 2010 the key risk is the slow recovery of banking sector, which means limited credit availability. As a result, economic agents will not be able to attract new funds or restructure previous debts, which would hamper economic recovery. Another risk is related to the inability of the Government to finance projects within the framework of the EURO 2012. As a result Ukraine will not host the Football Championship that would damage foreign investments and some domestic sectors like construction.

Private Consumption: Real final consumption will decline by 11.6% in 2009

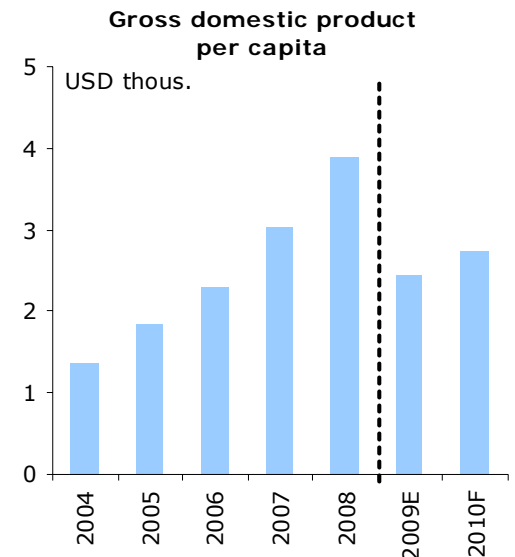
The contraction of the real private final consumption in the second quarter remained at the level of 11.6% as households spent less money for loan payments. In the second half of the year we expect similar rates of contraction. Thus, real private final consumption will drop by 11.6% in 2009. In particular, we expect larger net repayments on credits than in the first half of the year that will balance out a positive effect of increased nominal incomes. The household bank deposits will increase at a very slow pace.

The forecast of real private final consumption for 2010 was downgraded as we changed our assumption referring to the recovery of lending in the next year. The banks will increase lending slowly and the focus of the new lending is expected in the real sector. As a result, net lending to households will remain negative. The households will continue increasing deposits gradually against the background of relatively higher confidence in banking sector. The labour market is expected to remain weak, resulting in moderate growth of wage incomes. As a result, the Institute forecasts the real final consumption to grow by 1.0% in 2010.



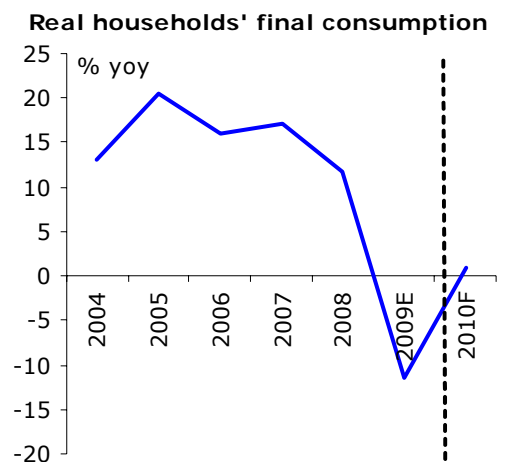
Note: E - estimate, F - forecast

Source: Derzhkomstat, IER calculations



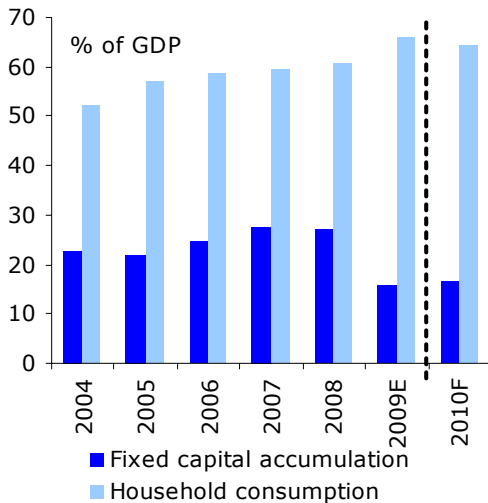
Note: E - estimate, F - forecast

Source: Derzhkomstat, IER calculations



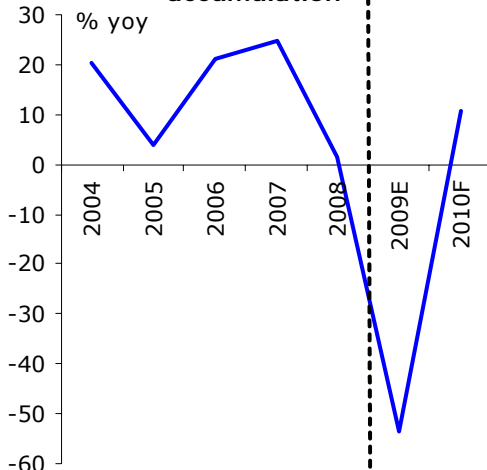
Note: E - estimate, F - forecast

Source: Derzhkomstat, IER calculations

Structure of gross domestic product


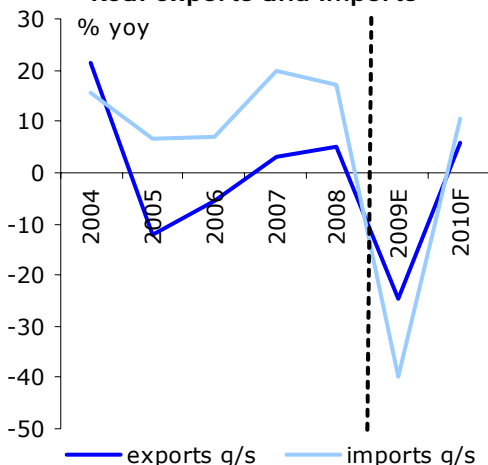
Note: E - estimate, F - forecast

Source: Derzhkomstat, IER calculations

Real gross fixed capital accumulation


Note: E - estimate, F - forecast

Source: Derzhkomstat, IER calculations

Real exports and imports


Note: E - estimate, F - forecast

Source: Derzhkomstat, IER calculations

Investments: Recovery is expected in 2010

Recent developments in investment activity reinforced our gloomy outlook for real gross fixed capital accumulation growth in 2009. In the second quarter of 2009, real gross fixed capital accumulation decreased by 57.9% yoy as the traditional increase in investment activity in the second quarter did not show up reflecting the difficult financial situation at national corporations and credit crunch. In addition the risk aversion among both the national and foreign investors remains high as the current business conditions and political situation continued worsening. We expect limited increase in investments in the second half of 2009 on a quarterly basis as economic prospects become more definite and an ability to postpone planned investments decrease.

In 2009, the most difficult situation with investments will be in residential construction. Private construction companies failed to improve their cash position despite discounted house prices on primary market. Infrastructure construction is expected to be in a little bit better shape by the end of the year.

We expect some acceleration of other types of investment activity in the last two quarters of 2009, namely purchases of machinery and equipment and intangible assets. The largest industrial corporations in machinery, metallurgy and service sector will resume funding of investments projects aimed at improving cost efficiency, modernising equipment and optimization of business processes supported by stabilization of prices at the external markets and lending from parent companies. From the other side, the bank credits for investments projects will be hardly available till the end of 2009.

In general, the IER foresees the more rapid decrease in real gross fixed capital accumulation growth in 2009 than previously assumed taking into account bad results of the second quarter of the year. Due to moderate estimations for investments revival in the last two quarters of 2009 we forecast the overall contraction of real gross fixed capital accumulation by 53.5% in 2009.

For 2010, the IER forecasts growth of real gross fixed capital accumulation due to low statistical base in 2009 and gradual recovery of economic activity in the country. According to our estimations, a bulk of investments will go in infrastructure and modernization projects while residential construction will remain stagnant. At the same time, industrial companies are expected to have better cash flow to finance investments supported by revival of banking system. There also will be acceleration of investments in construction of objects for EURO 2012, primarily at the expense of public funds. As a result, it is forecasted that real gross fixed capital accumulation will grow at 10.8% in 2010.

In 2009 we keep our previous forecast of reduction in stock of inventories accumulated by enterprises during the crisis. It will decline by the UAH 19 bn because enterprises suffer from demand shock and make sales primarily from finished goods stock.

External trade: The forecast of real exports in 2009 was downgraded

In the third quarter of 2009 conditions on key export markets for national companies remained primarily unfavourable. External demand on major commodities markets was weak and fluctuating. After gradual increase in prices and volumes on the world steel market in the second and third quarter of 2009, present demand and prices remained weak and are likely to remain so in the near future. We downgraded our forecast for real export contraction to 24.6% in 2009.

On the other hand, we slightly upgraded the real imports decline up to 39.8%. We downgraded our outlook on import of durables and investments goods growth due to stagnant investment demand and effect of import substitution.

For 2010 we expect gradual recovery of external trade flows thank to more optimistic outlook for external demand in the second half of the year. Economic growth in China and recovery of other emerging

economies countries based in part on stimulus packages around the world will create preconditions for real demand growth for commodities and machinery products produced in Ukraine. As a result, the IER forecasts real exports growth at 6.0% in 2010. On the other hand, we expect more rapid increase in real imports at 10.7% in 2010 driven mainly by demand for imported investment goods and durables.

Production: Upward revision for some sectors

The major industries of Ukrainian economy continued to suffer from weak demand that pushed numbers for real value added down for 2009. However, monthly output growth in some sectors allows us to improve our estimate of their growth in the second half of 2009.

More optimistic data on crops yields and output of livestock sector in the third quarter of 2009 allowed revising decline in real value added in agriculture in 2009 to 4.1%. Favourable conditions at the external grain markets, widening areas under crops and improving technologies in the sector will result in real value added growth at 3.6% in 2010.

We preserve forecast of deep contraction in real value added for manufacturing and construction. Manufacturing industry is heavily dependent from the external demand for commodities while construction requires investment. Following the stagnation on international commodities markets and negative forecast for investments the IER forecasts real value added decline in manufacturing industry at 26.8% and 41.5% in construction in 2009. For 2010 we assume moderate recovery of these industries supported by improving external conditions, public investments in infrastructure projects, and growing need in construction after low investments in 2009. As the result, we forecast real added value growth in 2010 in manufacturing industry and construction at 9.2% and 8.7%, accordingly.

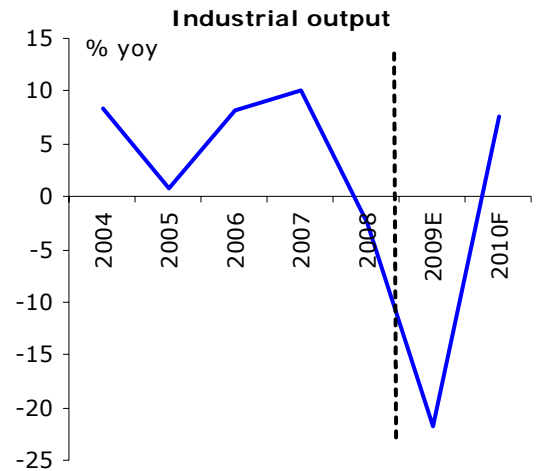
We expect the growth observed in the third quarter in transport and trade will continue in the last quarter. Therefore we changed the forecast for real value added decline for trade and transport services to 12.5% and 6.2%, accordingly. The moderate recovery of industrial production allowed improving the real value added growth for above-mentioned sectors to 5.7% and 6.5% in 2010.

Risk assessment

Pessimistic scenario: The key risk for economic development in 2009 is slower global economic recovery than assumed under the base scenario and higher political instability. In this case real fixed capital accumulation will reduce by 57.0%, while real private final consumption of households will decline by 12.1% in 2009. At the same time, external trade will deteriorate more. Under this scenario, the real GDP contraction is expected at 16.2% in 2009.

In 2010 the major impediment for economic recovery will be slow recovery of banking sector, which would result in limited crediting. It will limit investment potential of Ukrainian enterprises, having negative multiplicative impact on the whole economy. Another risk is related with the inability of the Government to finance projects required in the framework of the EURO 2012. Under this scenario real GDP will decline by 0.2%.

Optimistic scenario: Faster recovery of external demand and stable economic and political conditions in Ukraine may facilitate business confidence and thus accelerate investment activity in the end of 2009 and in 2010. In this case the IER expects real GDP to decline by 13.4% in 2009, while in 2010 real GDP will grow by 5.2%.



Note: E - estimate, F - forecast

Source: Derzhkomstat, IER calculations

Contributions to real GDP change under different scenarios, demand side view

Expressed as percentage points of GDP change

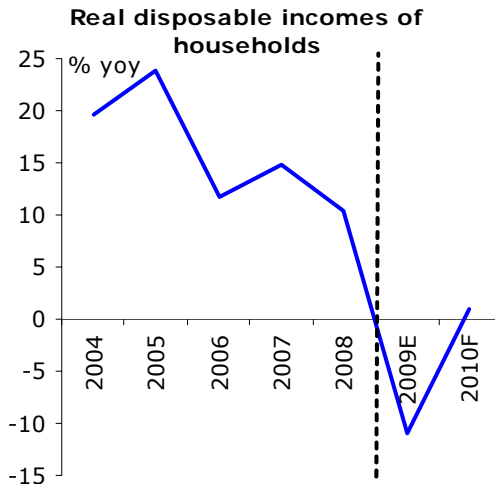
	P	B	O
	2009		
Real GDP	-16.2	-15.0	-13.4
<i>Contributions:</i>			
Private consumption	-7.8	-7.4	-6.6
Government consumption	-0.9	-0.6	-0.1
Gross fixed capital accumulation	-15.6	-14.7	-14.1
Inventories	-3.9	-3.8	-3.4
Net exports	12.2	11.7	11.3
	2010		
Real GDP	-0.2	3.4	5.2
<i>Contributions:</i>			
Private consumption	-3.1	0.7	2.6
Government consumption	0.0	0.5	0.6
Gross fixed capital accumulation	0.8	1.6	2.0
Inventories	2.7	2.6	2.1
Net exports	-0.6	-1.9	-2.2
Real GDP	-0.2	3.4	5.2

Note: P – pessimistic, B – base, O – optimistic scenario

Source: IER calculations

DISPOSABLE INCOMES AND UNEMPLOYMENT

Households: Real disposable incomes will decline by 10.9% in 2009



Note: E - estimate, F - forecast

Source: Derhkomstat, IER calculations

Real disposable incomes of households in the second quarter of 2009 declined by 8.3% yoy decelerating from 12.9% yoy contraction in the first quarter. Nominal incomes grew by 5.5% yoy. Weak labour market resulted in the contraction of real wage incomes by 10.9% yoy. As we expected the unemployment rate (ILO methodology) remained high, though declining to 8.6% of economically active population between 15 and 70 years old in the second quarter of 2009. At the same time, incomes from social assistance and current transfers dropped only by 3.1% in real terms.

We assume that social standards will not be increased this year above the levels foreseen in the State Budget Law for 2009 passed in December 2008. So, moderate wage increase against the background of reduced employment will further depress incomes for the rest of the year. Taking into account recent wage developments we estimate the average wage for 2009 at UAH 1930. As previously we estimate the unemployment rate (ILO methodology) at 9.5% of economically active individuals between 15 and 70 years old as the unemployment rate is expected to increase in the fourth quarter of the year. Thus, real wage incomes are expected to fall by 12.4% in 2009.

Taking into account recent data we downgraded the forecast of nominal increase in households' incomes from entrepreneurship and agriculture to 0.9%. Nominal incomes from social assistance and current transfers will increase by near 10% in 2009.

As a result, real households disposable incomes are expected to decline by 10.9% in 2009.

In 2010 wage incomes are expected to start growing in real terms (by 4.0%) thanks to economic recovery. Average nominal wage will reach UAH 2240, while unemployment rate (ILO methodology) will decline to 8.8%. Real incomes received from social assistance payments and current transfers will increase by 3.2%, while real incomes from entrepreneurship and agriculture will remain very close to previous year levels. As a result, real disposable income is forecasted to grow by 1.0%.

Incomes and unemployment under different scenarios

	P	B	O
2009			
Real disposable incomes, % yoy	-11.5	-10.9	-9.3
Unemployment rate*, %	10.0	9.5	8.7
2010			
Real disposable incomes, % yoy	-6.8	1.0	2.0
Unemployment rate*, %	9.8	8.8	8.0

* ILO methodology, economically active individuals aged between 15 and 70 years old

Note: P - pessimistic, B - base, O - optimistic scenario

Source: IER calculations

Risk assessment

Pessimistic scenario: Under the pessimistic scenario, the deeper deterioration of financial state of enterprises as well as rapid increase in social standards will push employers to cut employment at a higher pace. As a result, unemployment rate will be higher both in 2009 and 2010. At the same time, the wage differentiation will decrease. As a result, real disposable incomes of households are estimated to drop by 11.5% in 2009 and further decline by 6.8% in 2010.

Optimistic scenario: Under the optimistic scenario the real disposable incomes of households will decline by 9.3% in 2009 and their increase by 2.0% in 2010.

FISCAL INDICATORS

Consolidated fiscal revenues: The nominal revenues decline in 2009

As we expected the consolidated fiscal revenues deteriorated in the third quarter of 2009. As a result, between January and September the revenues declined by 10.5% yoy, or UAH 22.9 bn. The revenues from the major taxes diminished. In particular, the EPT revenues declined by 25.8% yoy, while VAT collections contracted by 22.7% yoy. The revenues from taxes on international trade almost halved. At the same time, excise revenues increased by near 60% yoy against the background of higher excise tax rates.

The fiscal stance will remain difficult till the end of 2009. The EPT revenues will remain depressed due to low enterprise profits and lower EPT advanced payments widespread in previous periods. At the same time, some EPT receipts might be ensured thanks to administrative pressure on state monopolies in the end of the year. Slight revival of nominal imports in the end of the year should enable the Government to collect additional revenues from VAT and taxes on international trade. Higher revenues from excises will be insufficient to balance other revenue losses.

Thus, taking into account low imports, weak labour market and widespread corporate losses, we expect consolidated fiscal revenues to reduce to UAH 265 bn or 30.2% of GDP in 2009. They will be 10.9% lower than in 2008. As the expected revenues are lower than planned in the State Budget for 2009, the Government will stay under a permanent pressure to find additional funds to finance its obligations.

In 2010 the consolidated fiscal revenues are expected to increase to UAH 309 bn, but will remain unchanged in relation to GDP. We expect the increase in share of tax revenues primarily thanks to higher VAT collections.

Within the forecast period the VAT will remain the major source of revenue accounting for around 30.8% of total consolidated fiscal revenues. At the same time, the EPT and PIT shares will decline as compared to 2008.

VAT: The VAT revenues are estimated to decline to 8.9% of GDP in 2009

Between January and September 2009 the VAT revenues dropped by 22.7% yoy primarily due to sharp reduction in imports and increase in VAT refund payments. The latter is explained by higher VAT refund to the Naftogas, however the VAT refund arrears increased by 25.6% to UAH 4.9 bn since the beginning for the year. Besides, it should be noted that the VAT revenues include the tax receipts from the custom clearance of disputed gas (UAH 1.5 bn).

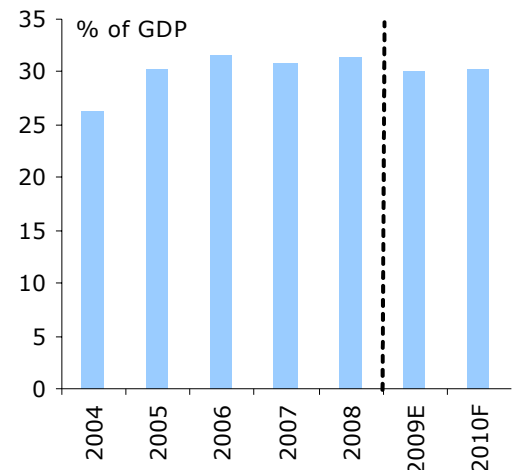
Taking into account current trends of the VAT revenues as well as revised IER forecasts of foreign trade, we downgrade the VAT revenues estimate for 2009 to UAH 78.2 bn. The collections from this tax will be by 17.7% lower than in 2008. We do not expect further accumulation of VAT refund arrears by the end of year. The VAT revenues will also decline in relation to GDP (to 8.9%), still remaining the largest source of total consolidated revenues.

We decreased our projections for VAT revenues in 2010 to UAH 95.3 bn or 9.2% of GDP primarily due to lower than previously expected nominal imports. For the next year we do not assume accumulation of further arrears on VAT refunds.

EPT: Enterprise profit tax will decline at 31% yoy in 2009

During the third quarter of 2009 the EPT revenues collection continued to decline due to falling corporate profits. In the third quarter of 2009 the EPT revenues fell by 32% yoy which is faster than in previous quarters. The major reason for the worsening was falling corporate profits between January and August that declined at 38.9% yoy as compared to 34.2% yoy in the first half of 2009.

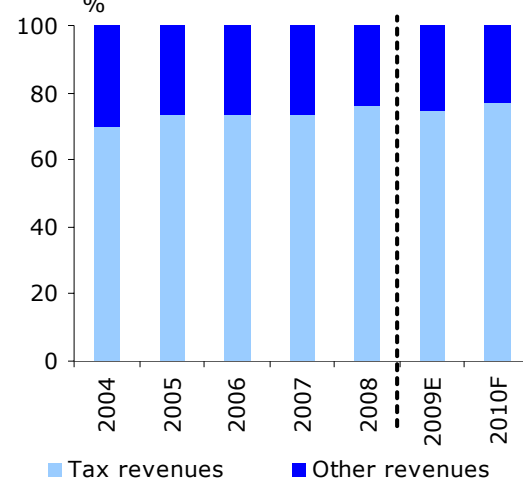
Consolidated fiscal revenues



Note: E - estimate, F - forecast

Source: State Treasury Reports, IER calculations

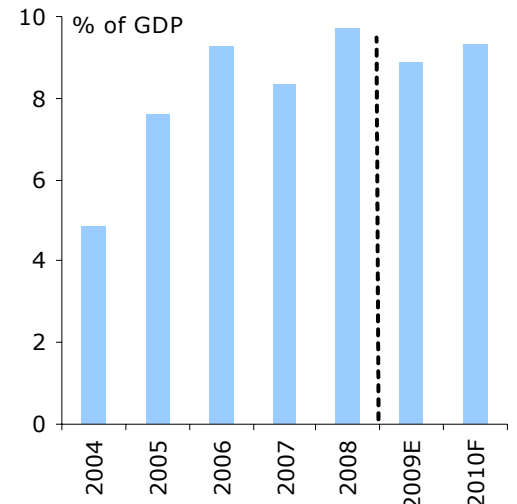
Consolidated fiscal revenues structure



Note: E - estimate, F - forecast

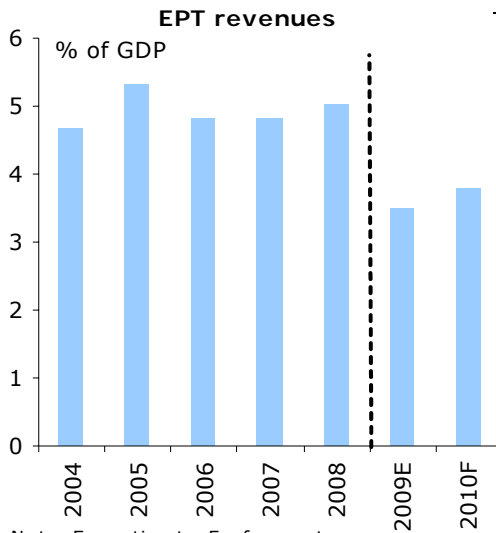
Source: State Treasury Reports, IER calculations

VAT revenues



Note: E - estimate, F - forecast

Source: State Treasury Reports, IER calculations



Note: E - estimate, F - forecast
Source: State Treasury Reports, IER calculations

Besides, the Government decided to grant the EPT privileges to NJS Naftogas estimated to reach UAH 7 bn in 2009. We expect slight revival of economic activity in the fourth quarter of 2009 that will somewhat improve total revenues allowing keeping forecast of EPT revenues in 2009 at UAH 30.8 bn or 3.5% of GDP.

In 2010 we expect gradual recovery of corporate profits based on assumption that both external and internal conditions for business will improve. First, major corporations in metallurgy and machinery will favour from price recovery in main export markets. Second, increase in state investments in infrastructure projects and government purchases of goods and services will contribute to profits growth. Thus, we slightly improved our forecast of the EPT revenues in 2010 to UAH 38.9 bn or 3.8% of GDP.

PIT: Revenues from the personal income tax will reach UAH 50.2 bn in 2010

PIT revenues during first nine months of 2009 declined by 3.9% or UAH 1.3 bn as compared to the same period of last year. First, gross wages somewhat declined on the back of moderate wage increase and declined employment. Besides, higher minimum wage as of January 2009 resulted in higher PIT deductions. At the same time, employers seem to still avoid paying wages below the level making employees eligible for the social privilege. In such a way employers try to escape additional attention of the tax administration, but this behaviour also ensures some gross wage rigidity. As a result, the PIT revenues for 2009 are expected at UAH 44.0 bn, which is by 4.1% lower than last year. The PIT receipts will be at 5.0% of GDP, becoming the second largest tax revenues source for the consolidated budget.

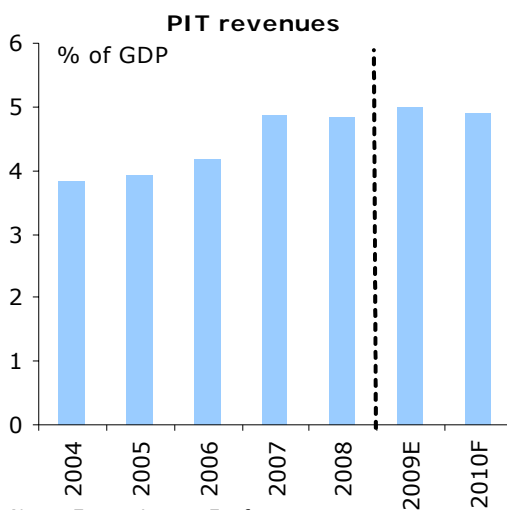
The subsistence minimum level is expected to be increased at least by 10% from January 1, 2010, resulting in higher minimum wage. As a result, both PIT deduction amount and number of persons eligible for the privilege will increase. The negative impact of this increase on the PIT revenues will be more than counterweighted by increase in gross wages and continuation of employers' wage policies. As a result, the PIT revenues are forecast at UAH 50.2 bn or 4.9% of GDP.

Consolidated fiscal expenditures: The expenditures will increase to 35.7% of GDP in 2009

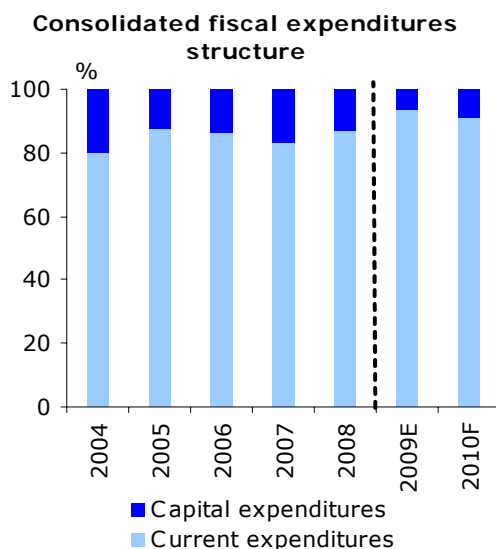
The consolidated fiscal expenditures increased by 6.1% yoy in the first three quarters of 2009 because the Government was able to receive external funding to finance its obligations against the background of drop in revenues. Current expenditures increased by 12.6% yoy, while capital expenditures almost halved as compared to the same period of last year.

Following these trends in 2009 the current expenditures will increase as compared to 2008, while the capital expenditures will sharply decline and constitute only 2.2% of GDP. Total consolidated fiscal expenditures in 2009 are expected to remain close to levels of last year due to several reasons. First, the capacity of the Government to attract further financing is limited. Second, the Government will continue lending to the Pension Fund to cover cash flow gaps rather than increasing the special transfer to cover Fund's deficit. Besides, it is unlikely that the NBU will transfer UAH 9.8 bn to the central coffers as it is envisaged in the current version of the State Budget Law for 2009, as its profits will be lower this year.

The Institute forecasts the consolidated fiscal expenditures in 2010 at UAH 346 bn or 33.9% of GDP against the background of higher fiscal revenues, but lower fiscal deficit. The Government is expected to increase gas tariffs, which would constraint transfers to the NJSC Naftogaz. This measure along with some streamlined social assistance will enable the Government to reduce spending for current transfers and subsidies. At the same time, the purchase of goods and services will increase due to inflation partly associated with higher utility tariffs. The wage payments will also increase against the background of higher minimum wage and increased first tariff grade



Note: E - estimate, F - forecast
Source: State Treasury Reports, IER calculations



Note: E - estimate, F - forecast
Source: State Treasury Reports, IER calculations

of the Unified Tariff Scale (UTS) for paying wages in public sector. At the same time, we assume that the UTS will not be fully introduced in 2010. The debt servicing payments will increase to near UAH 18 bn. As a result, capital expenditures are forecasted to be still low at UAH 29.5 bn or 2.9% of GDP.

Consolidated fiscal balance: The consolidated fiscal deficit is expected to reach 5.6% of GDP in 2009

We forecast the consolidated fiscal deficit for 2009 at the level of UAH 47.3 bn or 5.4% of GDP not taking into account the funds for banks' recapitalisation. Moreover, this deficit does not include the substantial credits, which are provided by the Government to the Pension Fund in 2009 to cover Fund's cash flow gaps. These loans are not currently reported in regular monthly State Treasury Reports. The cumulative amount of credits to the Fund might exceed UAH 12 bn, which would increase the fiscal deficit to 6.7% of GDP.

The expected structure of deficit financing was also changed. In particular, the foreign borrowing is anticipated to increase as we expect that the fourth IMF tranche (USD 4.0 bn) will be received and used for the deficit financing. This money will come in addition to USD 4.7 bn already received from previous IMF tranches for fiscal purposes (primarily, for external debt payments). Other external sources of financing are the loans from the World Bank and the EBRD.

As the Ministry of Finance will not be able to place large amounts of domestic state bonds till the end of the year, we downgraded the expected deficit financing from this source. We also declined the forecast of privatisation receipts due to failure of the Government to ensure sale of the Odessa By-Port Plant in 2009.

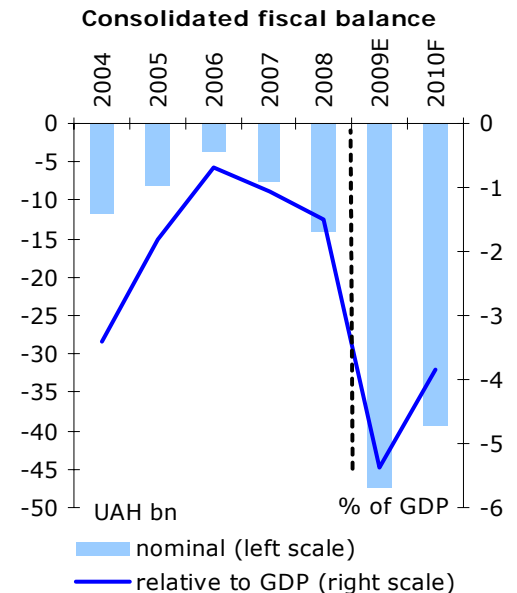
The direct state debt is estimated to double this year and reach 27.5% of GDP due to large amount of borrowings by the Government in 2009. However, the public debt of Ukraine will remain at a safe level and we do not expect sovereign default on external or domestic debt servicing and redemption payments.

In 2010, consolidated fiscal deficit is forecast at UAH 39.2 bn or 3.8% of GDP, which is higher than our previous estimate. The share of domestic borrowing in total financing will substantially increase to 76.0% in 2010, becoming the major source of consolidated fiscal deficit financing. In particular, the Government is expected to issue UAH 30.0 bn of domestic bonds at. The stabilisation of global financial market will enable the Government to attract USD 0.5 bn on external markets. Besides, additional funds are expected to be received from international financial institutions. At the same time, the Government will redeem domestic and external debt at near UAH 18 bn. Foreign and domestic borrowings will be sufficient to cover debt repayment and interest in 2010. The privatisation is expected to restore in 2010 thanks to stabilisation of political situation in the country ensuring privatisation at UAH 8.2 bn. The direct state debt will decline in relation to the GDP to 25.7% of GDP as the debt will grow slower than nominal GDP.

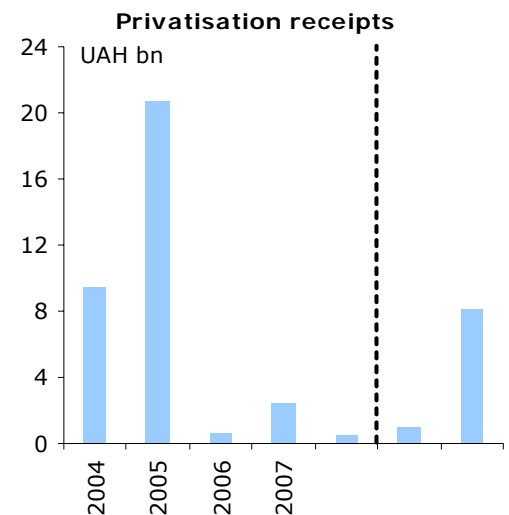
Risk assessment

Pessimistic scenario: In 2009 the fiscal position might be under additional pressure given deeper than expected economic recession. Besides, the additional pressure on the fiscal expenditures will be created if the Government will fulfil the law on increased social standards. As a result, the Government will not be able to receive the next IMF tranche. The Government will not be able to find adequate sources for financing higher liabilities to compensate for lower external lending. So, the Government will face real problems in financing its major liabilities, including wage and pension payments. In this situation all fiscal indicators, namely revenues, expenditures and deficit in 2009 will be lower under the risk scenario.

Under this scenario in 2010 the fiscal revenues will increase to UAH 301 bn. At the same time, the deficit is expected to be lower than under base scenario due to restricted opportunities to attract required financing.



Note: E - estimate, F - forecast
Source: State Treasury Reports, IER calculations



Note: E - estimate, F - forecast
Source: State Treasury of Ukraine

Fiscal indicators under different scenarios

% of GDP	% of GDP		
	P	B	O
2009			
Consolidated fiscal revenues	29.1	30.2	30.3
Capital expenditures	1.9	2.2	3.8
Consolidated fiscal deficit	-4.9	-5.4	-6.1
2010			
Consolidated fiscal revenues	28.8	30.2	29.8
Capital expenditures	2.4	2.9	4.3
Consolidated fiscal deficit	-2.8	-3.8	-3.1

Note: P - pessimistic, B - base, O - optimistic scenario
Source: IER calculations



Optimistic scenario: Under the optimistic scenario the consolidated fiscal revenues are estimated at UAH 284 bn in 2009. The fiscal deficit will be at 6.1% of GDP. In 2010 the consolidated fiscal revenues are forecast at UAH 336 bn.

BALANCE OF PAYMENTS

Current account: Current account deficit will stay at around 1% of GDP in 2009-2010

According to the NBU preliminary estimates in the first three quarters of 2009 current account deficit narrowed comparing with 2008 figure and reached USD 1.0 bn thanks to decrease in commodity trade deficit caused by import plunge. We expect the trend to be supported till the end of the year. The part of commodity trade deficit will be compensated by service trade surplus and net inflow of current transfers. In result, current account deficit will equate USD 1.1 bn (1.0% of GDP) in 2009. In 2010, the deficit will stay almost the same at USD 1.3 bn (1.1% of GDP).

In the three quarters of 2009 commodity exports and imports decreased by 48.2% yoy and 52.6% yoy in dollar terms, respectively. The contraction decelerated compared to the first half of the year. We forecast that commodity import will continue to rebound due to revival in imports of cars freed from administrative restrictions. Energy imports will also restore while gas purchases are expected to be lower than contracted. Thus, in 2009 merchandise import will decrease by 49.7%. The reduction in merchandise exports is expected to decelerate further. We changed our forecast for 2009 to 43.3% in line with September exports revival on main commodity groups.

We expect commodity imports to restore faster than exports in 2010. They will grow by 17.6% and 15.1% in dollar terms, respectively. Commodity exports will be triggering by increasing demand for metals and machine building products. At the same time exports of agricultural production will somewhat reduce due to lower grain harvest. 2010 will be marked by increase in imports on all commodity groups with the highest growth in imports of energy materials based on contracted volumes of gas purchases. Investments revival will also support commodity imports increase. Thus, commodity trade deficit will be at USD 5.8 bn in 2010 as compared to USD 4.1 bn in 2009.

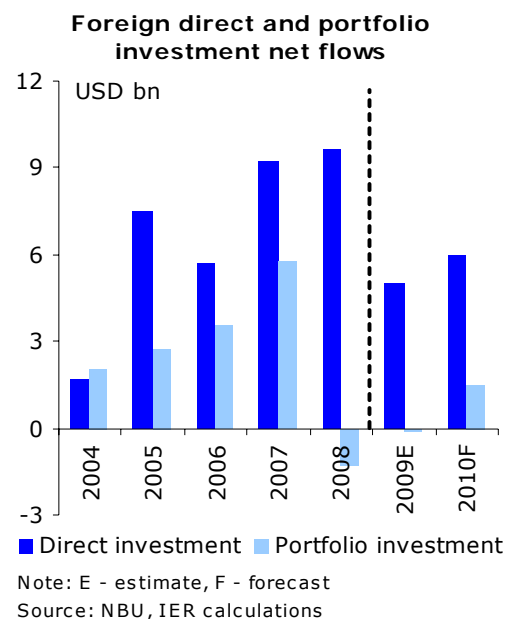
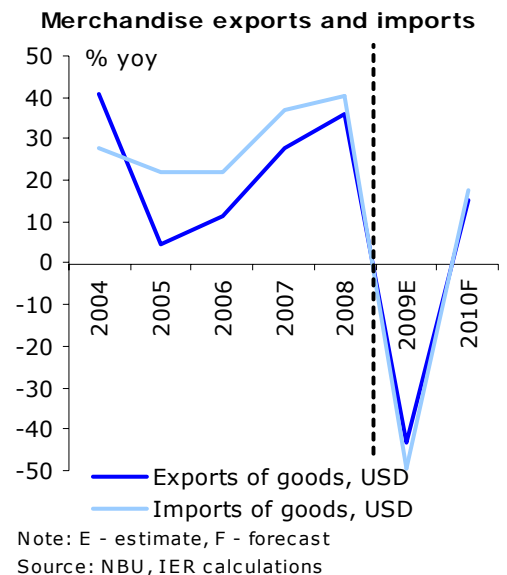
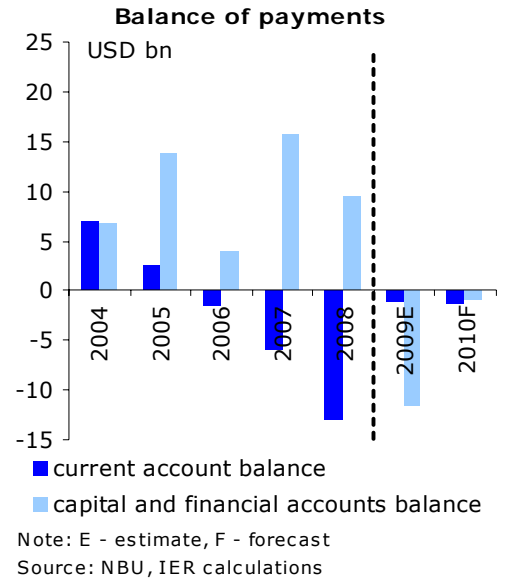
The services exports drop for 2009 was downgraded to 22.8% in dollar terms in line with first half of 2009 decrease in demand for transportation. The figure for imports fall remained almost unchanged at 25.2% in dollar terms, depressed by decreased demand for travels and transportation services. In 2010, exports of services will rebound faster than imports. Service exports and imports will grow at 12.3% and 11.4%, respectively. In result, services trade surplus will widen to USD 2.6 bn in 2010 from USD 2.2 bn in 2009.

Net inflow of current transfers will increase from USD 3.0 bn in 2009 to USD 3.2 bn in 2010 reflecting general revival at international markets. The forecast for net outflow of incomes was slightly downgraded to USD 2.2 bn in 2009 adjusted for the result of the first three quarters. In 2010 net outflow of incomes will narrow to USD 1.3 bn on the back of lower profits in 2009.

Capital and financial accounts: Financial account will be in deficit in 2010

In 2009, IMF and NBU reserves will be extensively used to cover both current and financial accounts deficits. The total spending will reach USD 12.5 bn. In 2010 no new IMF instalments will be attracted.

According to the NBU preliminary estimates between January and September 2009 financial account deficit was at USD 11.2 bn mostly accumulated in the first and third quarters of 2009 due to significant increase in foreign cash outside banks. Nine-month FDI inflow figure was comparable to one-quarter figure in the beginning of 2008, while payments on external debts of banking and public institutions were considerable. We expect that lower demand for foreign cash will bring some stabilization at financial markets; however, another wave of external debts payments is expected. Thus, net outflow of other



Balance of payment indicators under different scenarios

USD bn

	<i>P</i>	<i>B</i>	<i>O</i>
2009			
Current account balance	-3.8	-1.1	-0.5
Capital and financial account balance	-8.6	-11.5	-9.0
2010			
Current account balance	-2.4	-1.3	1.1
Capital and financial account balance	-4.2	-1.0	1.3

Note: P – pessimistic, B – base, O – optimistic scenario

Source: IER calculations

investment is forecasted at USD 16.5 bn in 2009. An increase in net outflow on this position will be only partly offset by FDI inflow. So, financial account deficit will reach USD 11.5 bn in 2009.

We stick to our assumption of foreign investors' activity revival in 2010. Among key factors of improvement on financial account side are infrastructure projects related to the EURO-2012 and modernisation of energy sector which will drive net FDI inflow to USD 6.0 bn in 2010. Renewal of investors' activity will result in portfolio inflows offsetting outflows, so that net position will equate USD 1.5 bn. Other investment net outflow will reduce to USD 8.5 bn in line with planned debt repayments. Thus, in 2010 financial account will be in deficit at USD 1.0 bn.

Risk assessment

Pessimistic scenario: Under the pessimistic scenario the current account balance will be in deficit in 2009 and 2010 at USD 3.8 bn and USD 2.4 bn, respectively. Financial account deficits are forecasted at USD 8.6 bn in 2009 and USD 4.2 bn in 2010.

Optimistic scenario: More pronounced revival of international trade will result in higher than under the base scenario current account surplus in 2010 (at USD 1.1 bn). On the financial side wider possibilities for debt refinancing and new loans are expected turning the financial account balance positive.

MONETARY SURVEY AND INFLATION

Monetary policy: Monetary policy guidelines for 2010

In September, the NBU Council approved monetary policy guidelines for 2010. The guidelines confirmed the intention of the NBU to switch to floating exchange rate and inflation targeting over the medium term. For 2010 the NBU intends to use targets for international reserves and monetary base agreed with IMF as anchors for monetary policy with monetary base growth expected within 9-13% range. Thus, the NBU promised to maintain relatively tight monetary policy.

However, exact targets for 2010 under the IMF program are expected to be announced in February 2010. Currently there is considerable uncertainty over the NBU policy in 2010 as it is unclear whether IMF program will continue the next year. Besides the new NBU management expected in 2010 may change the direction of the monetary policy. However, we assume relatively tight monetary policy and limited interventions in the foreign currency market in this forecast.

Monetary aggregates: Money supply will renew its growth in 2010

Money supply (M2) is expected to decrease by 5.6% or to UAH 484 bn in 2009, although it will improve slightly from UAH 467 bn level recorded in September. Foreign currency deposits will decline by 19.7% eop. National currency time deposits will reduce by 27.1% remaining at the levels close September.

In 2010, money supply will grow by 18.4% and reach UAH 573 bn by the end of the year. This growth will be driven by increases in cash and foreign currency deposits as confidence in the banking system will not improve substantially. Cash and foreign currency deposits are forecasted to increase by UAH 62 bn in 2010, while money supply will increase by UAH 89 bn.

On the asset side, provision of credit to private sector will be constrained by limited domestic and external funding. Claims of banks to private sector are forecasted to increase by 1.2% in 2009 to UAH 764 bn as state conducted quasi-fiscal operations through government-owned banks. In 2010 they will increase by 6.8% as financial sector will gradually resume lending to real sector and will reach UAH 816 bn by the end of 2010.

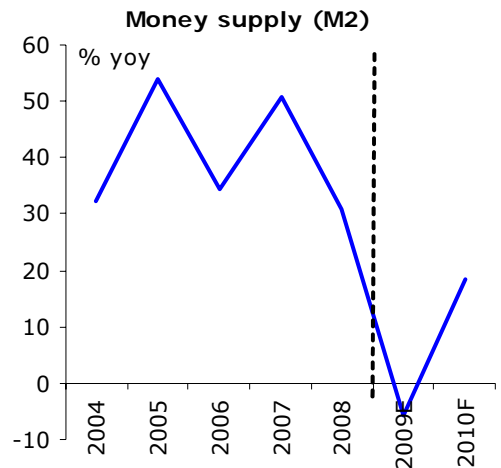
Inflation: Consumer inflation will decelerate in 2009 and 2010

Consumer inflation is forecast to slow compared to 2008, but remain in double digits with consumer prices growing at 15.4% as annual average in 2009 and at 13.7% yoy in December. Over the first three quarters of 2009 inflation slowed down significantly to 15.0% yoy in September from 22.3% yoy in December 2008 in part due to high statistical base. On the demand side, high unemployment, limited nominal incomes and high debt burden impaired purchasing power of households. On the supply side, falling labour costs and slower growth in prices for domestically produced items constrained inflation pressure. However, high inflation expectations contributed to price growth. These trends are expected to continue over the rest of 2009 as exchange rate fluctuations maintain high inflation expectations.

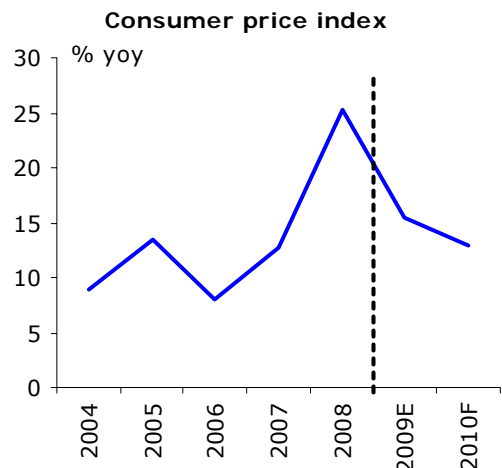
In 2010 consumer demand will be close to 2009 level while inflation expectations are likely to decrease somewhat as economic agents gradually adjust to the floating exchange rate. Increase in administered prices and international commodity prices will support the inflation in double digits. Thus inflation is expected to slow to 12.9% on average in 2010 and to 11.5% yoy in December 2010.

Exchange rate: Hryvnia will depreciate in 2010

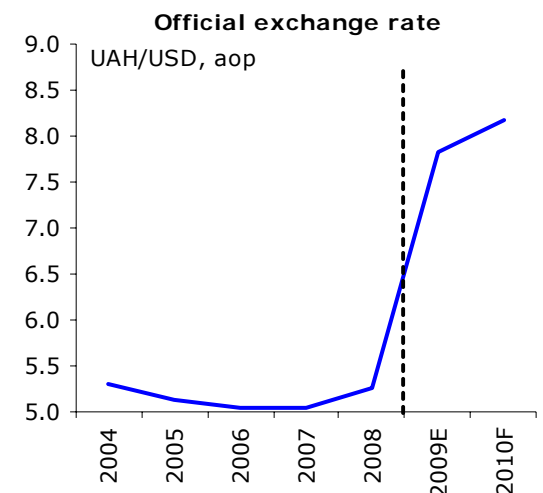
Over the first three quarters of 2009, the NBU managed to maintain exchange rate stability broadly taken as hryvnia mostly remained within UAH/USD 7.5-8.5 on the inter-bank market. In September and October hryvnia settled in the upper half of this range. We



Note: E - estimate, F - forecast
Source: NBU, IER calculations



Note: E - estimate, F - forecast
Source: Derzhkomstat, IER calculations



Note: E - estimate, F - forecast
Source: NBU, IER calculations

Monetary survey indicators under different scenarios

	<i>P</i>	<i>B</i>	<i>O</i>
		2009	
CPI, % aop	15.7	15.4	15.5
Money supply (M2), % yoy	-7.2	-5.6	-8.9
Official exchange rate, UAH/USD, aop	7.95	7.83	7.79
		2010	
CPI, % aop	21.2	12.9	13.9
Money supply (M2), % yoy	26.9	18.4	18.8
Official exchange rate, UAH/USD, aop	10.88	8.17	7.83

Note: P – pessimistic, B – base, O – optimistic scenario

Source: IER calculations

expect the inter-bank exchange rate to remain under UAH/USD 8.5 over the remaining months of the year. Official exchange rate is expected to track the inter-bank rate though it will be lower by 2-3% in 2009 and 2010. It will reach UAH/USD 7.83 aop in 2009 with average rate of UAH/USD 8.15 in the fourth quarter.

In 2010, improved exports and lower demand for cash foreign currency will help to increase foreign currency supply. At the same time, higher imports, high external debt payments estimated at over USD 20 bn, and growing hryvnya stock are expected to increase demand. On balance hryvnya is expected to weaken slightly. Thus, average official exchange rate is forecasted at 8.17 UAH/USD in 2010.

Risks assessment

Pessimistic scenario. If the global economic recovery will be slow and protracted and political instability will hamper the recovery in Ukraine, fiscal deficit financing with the help of the NBU will cause the inflation to accelerate in 2009 and 2010. In this case inflation will reach on average 15.7% in 2009 and 21.2% in 2010. Slow recovery and domestic instability will further increase difficulty of financing foreign capital outflows, while excessive supply of hryvnya and speculative demand are likely to increase depreciation pressure. Therefore, hryvnia is likely to reach UAH 7.95 per USD on average in 2009, with further depreciation to UAH 10.88 per USD in 2010.

Optimistic scenario. If economic recovery appears stronger than expected and consumer confidence supports demand, increased demand will push inflation in 2010 to 13.9% on average and 12.7% yoy in December. Demand for the foreign currency is forecasted to be weaker due to greater confidence in hryvnya. Thus, exchange rate will be stronger in 2010 at 7.83 UAH per USD as annual average.

TABLES
Table 1. National Accounts (GDP)

		2006	2007	2008	2009E	2010F
Nominal GDP	UAH bn	537.7	712.9	949.9	879.3	1022.7
	USD bn	106.5	141.2	180.3	112.3	125.2
Real GDP	% yoy	7.3	7.6	2.1	-15.0	3.4
GDP expenditure side components						
Private consumption, real	% yoy	15.9	17.1	11.8	-11.6	1.0
State consumption, real	% yoy	2.7	2.8	0.4	-3.7	2.3
Fixed capital accumulation, real	% yoy	21.2	24.8	1.6	-53.5	10.8
Exports, real	% yoy	-5.6	3.2	5.2	-24.6	6.0
Imports, real	% yoy	6.8	19.9	17.1	-39.8	10.7
GDP production side components						
Agriculture, real	% yoy	2.0	-5.0	17.2	-4.1	3.6
Extractive industry, real	% yoy	9.9	4.1	-1.5	-9.3	5.7
Manufacturing, real	% yoy	9.2	12.8	-2.3	-26.8	9.2
Production and distribution of electricity, gas and water, real	% yoy	0.1	1.3	-4.8	-12.8	3.4
Construction, real	% yoy	0.3	13.2	-17.5	-41.5	8.7
Trade, repair services, real	% yoy	17.7	20.6	1.8	-12.5	5.7
Transport, real	% yoy	7.6	11.0	7.1	-6.2	6.5
Education, real	% yoy	2.1	4.3	-0.4	-1.9	1.0
Health care, real	% yoy	2.4	-0.4	-0.4	-3.1	-0.5
Other types of economic activity, real	% yoy	5.7	6.0	1.9	-4.6	-0.3
Estimated payments to financial intermediaries, real	% yoy	59.6	30.0	-2.6	8.9	15.0
Net taxes on products, real	% yoy	13.4	4.9	8.0	-30.2	1.7

Table 2. Incomes and Unemployment rate

		2006	2007	2008	2009E	2010F
Real disposable incomes	% yoy	11.8	14.8	10.3	-10.9	1.0
Unemployment rate (ILO methodology, economically active individuals aged between 15 and 70 years old)	%	6.8	6.4	6.4	9.5	8.8

Table 3. Fiscal Indicators

		2006	2007	2008	2009E	2010F
Consolidated fiscal revenues	UAH bn	171.7	219.9	297.8	265.3	309.1
	% of GDP	31.6	30.8	31.4	30.2	30.2
EPT revenues	UAH bn	26.2	34.4	47.9	30.8	38.9
	% of GDP	4.8	4.8	5.0	3.5	3.8
VAT revenues	UAH bn	50.4	59.4	92.1	78.2	95.3
	% of GDP	9.3	8.3	9.7	8.9	9.3
PIT revenues	UAH bn	22.8	34.8	45.9	44.0	50.2
	% of GDP	4.2	4.9	4.8	5.0	4.9
Consolidated fiscal expenditures	UAH bn	175.3	226.0	309.2	307.6	346.3
	% of GDP	32.2	31.4	32.6	35.0	33.9
Current consolidated fiscal expenditures	% of GDP	27.7	26.0	28.2	32.8	31.0
Capital consolidated fiscal expenditures	% of GDP	4.5	5.4	4.3	2.2	2.9
Consolidated fiscal balance (without bank recapitalisation)	% of GDP	-0.7	-1.1	-1.5	-5.4	-3.8
Privatisation receipts	UAH bn	3.8	2.2	0.5	1.0	8.2

Table 4. Balance of Payments

		2006	2007	2008	2009E	2010F
Current Account balance	USD bn	-1.6	-5.9	-12.9	-1.1	-1.3
	% of GDP	-1.5	-4.2	-7.2	-1.0	-1.1
Exports of goods	USD bn	38.9	49.8	67.7	38.4	44.2
Imports of goods	USD bn	-44.1	-60.4	-84.7	-42.6	-50.0
Balance of services	USD bn	2.1	2.7	2.4	2.2	2.6
Capital and Financial Accounts	USD bn	3.9	15.8	9.5	-11.5	-1.0
Direct investments	USD bn	5.7	9.2	9.7	5.0	6.0
Portfolio investments	USD bn	3.6	5.8	x	-0.1	1.5
Other investments	USD bn	-5.4	0.8	x	-16.5	-8.5

Table 5. Monetary Aggregates and CPI

		2006	2007	2008	2009E	2010F
Money supply (M2)	UAH bn	259.4	391.3	512.5	483.9	572.9
	% yoy	34.3	50.8	31.0	-5.6	18.4
Consumer price index (CPI)	% yoy aop	8.0	12.8	25.2	15.4	12.9
	% yoy eop	11.6	16.6	22.3	13.7	11.5
Exchange rate (official)	USD aop	5.05	5.05	5.27	7.83	8.17
	USD eop	5.05	5.05	7.70	8.15	8.17

Note: E - estimate, F - forecast, yoy - year-on-year change, aop - average of the period, eop - end of period

Source: State Statistics Committee, NBU, State Treasury, IER forecasts and estimates

ASSUMPTIONS OF THE FORECAST

BASE and OPTIMISTIC scenario

Under the Optimistic scenario we assume higher consumer and business confidence than under the Base scenario. Other assumptions do not differ.

- The global economy will not face another round of economic and financial crisis in 2009 and in 2010.
- Ukraine together with Poland will host the EURO 2012, which will create stimulus for investments into infrastructure projects.
- The world prices for crude oil (*Brent*) will be at USD 60 per barrel on average in 2009 and reach USD 60-70 per barrel on average in 2010.
- Metal prices (FOB *Black sea*) will start growing in the second quarter of 2010.
- External demand for Ukrainian steel will be stagnant in the second half of 2009 and partially recover in 2010.
- The demand for machine building production of Ukraine will remain stagnant in CIS countries in the second half of 2009, but will partly recover in 2010.
- VAT refund overdue arrears will be accumulated in 2009 and somewhat decline in 2010.
- The advance EPT payments will be lower in the second half of 2009 and in 2010.
- Social standards will not be increased above the levels envisaged in the State Budget Law for 2009 approved on December 26, 2008.
- The subsistence minimum and, thus, minimum wage and minimum pension, will be indexed for officially projected inflation in 2010.
- Social assistance and state support programs will be somewhat streamlined in 2009 and 2010.
- The share of shadow economy will increase in 2009, but somewhat decline in 2010.
- Utility, gas and electricity tariffs for population will be increased in 2010.
- The Government will receive loans from the World Bank and the EBRD in 2009 and 2010.
- The Government will provide lending to the Pension Fund to cover the Fund's cash flow gaps, which are not reported in the regular State Treasury reports.
- The Unified Tariff Scale for paying wages in public sector will not be fully implemented in 2010.
- The NBU will continue to make interventions in the second half of 2009 to smooth exchange rate fluctuations, but the volumes will be limited. In 2010 the exchange rate will be in managed float.
- In 2009 financial sector will remain functioning as deposit protection will be paid in full and the NBU and the Government will support most of large banks that have problems.
- Mass defaults in real sector will not occur in 2009 and 2010.
- The fourth IMF tranche will be received and used for the deficit financing.

Pessimistic scenario (assumption that differ from the BASE and OPTIMISTIC scenario)

- The global economy will start growing on a quarterly basis only in the second quarter of 2010.
- Ukraine will loose its right to host the EURO 2012.
- The world price for crude oil (*Brent*) will be at USD 55 per barrel in 2009 and at USD 65 per in 2010.
- Global metal prices (FOB *Black sea*) will start growing in the middle of 2010.
- External demand for machinery will remain low till the end of 2010.
- The weather conditions in Ukraine will not be favourable for grains production.
- VAT refund overdue arrears will be accumulated in 2010.
- Tax payments arrears will be accumulated throughout entire forecast period.
- Social standards will be increased above the levels of officially projected inflation in 2010.
- Economy will suffer from widespread credit defaults in the real sector in the second half of 2009 and in 2010.
- Financial sector will suffer large losses and several large banks will fail in the second half of 2009 and in 2010.
- IMF will refuse to cooperate with Ukraine and no other instalments of loan will be disbursed.

INSTITUTE FOR ECONOMIC RESEARCH AND POLICY CONSULTING

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Contributing to the development of economic and political sciences as well as promoting development of Ukrainian research community.

PRODUCTS

Monthly Economic Monitor Ukraine (MEMU) with supplement

The MEMU contains a monthly review and brief analysis of the key economic policy measures and data that come public during the previous month. The MEMU supplement presents extended analysis of one key event in the Ukrainian economy. There are 12 issues per year distributed among subscribers.

Macroeconomic Forecast of Ukraine (MEFU)

The MEFU includes forecast of the GDP and its components, fiscal indicators, balance of payments, inflation, exchange rate for current and next years. There are 12 issues per year – 4 quarterly issues and 8 updates with short comments – distributed among subscribers.

Infrastructure Monitoring of Ukraine (IMU)

The IMU is an annual report that presents information on the restructuring of six key infrastructure sectors of the Ukrainian economy in a standardized manner, which allows for cross-industry comparisons. Monitored indicators are qualitative and fall into three broad categories: (1) commercialisation, (2) tariff reform, and (3) regulatory and institutional development. Twenty-one indicators allow for economic and policy-making analysis at different aggregation levels. It is distributed free of charge.

Economic Summary for Ukraine

Economic summary is a review and brief analysis of the key economic indicators and policy measures of the year. It is published in January using the available statistics and annual estimates and updated in May when the most of previous year data becomes publicly available. The product is distributed among subscribers.

Business Tendencies Survey

Business Tendency Surveys are comprised of two surveys. The first one – Industries – is prepared on the basis of quarterly surveys of industrial enterprises managers. The second – Banking – is based on the survey of banks managers. There are four publications for each of the component of the Business Tendencies available to participants of the surveys and to subscribers.

Policy Papers

The policy papers are the joint product of the German Advisory Group for Economic Reforms in Ukraine and the IER aimed at providing economic policy recommendations to Ukraine's policy makers. The recommendations are based on the careful analysis of Ukraine's situation, state-of-the-art economic theory, and best international practices. The papers are available for policy makers and – with some time lag – for general public. The list of the most recent policy papers includes:

- The gas challenge. On securing natural gas transits and stabilising the domestic market in Ukraine, by Ferdinand Pavel, and Dmytro Naumenko. Policy Paper 04, July 2009
- Only the fast privatization of Ukrtelecom will secure the further development of the telecommunication sector in Ukraine. by Lard Handrich. Policy Paper 03, July 2009
- How to develop a public debt market for retail investors? by Robert Kirchner, Ricardo Giucci, and Vitaliy Kravchuk. Policy Paper 02, July 2009
- The Role of Trade Policy in Reducing Ukraine's Current Account Deficit - Lessons from Abroad, by Christian Helmers, Veronika Movchan, Ricardo Giucci and Kateryna Kutsenko, policy Paper 01, March 2009

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