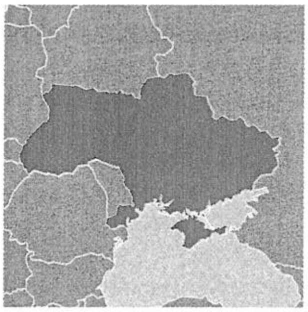
Ukraine



Outlook

Exports and base effects have helped the economy to growth by +5% in 1H10, however, we see the momentum fading in the coming quarters, as reforms have been slow. One of the positive factors however, is the potential towards acceleration of EURO2012 infrastructure projects in the coming quarters, which could give an additional boost to growth. Lack of an IMF program, implies that the NBU needs to build a greater FX cushion, and will continue to intervene on the FX market keeping the UAH stable in the coming months.

Author: Dmitry Gourov, Economist (UniCredit CAIB)
+43 50505 82364, dmitry.gourov@caib.unicreditgroup.eu

	Moody's	S&P	Fitch
Long-term foreign currency credit rating	B2 negative	B stable	B- stable

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	103.1	123.4	81.4	114.6	156.9
Population (mn)	46.6	46.4	46.1	45.8	45.5
GDP per capita (EUR)	2,210	2,661	1,766	2,504	3,447
GDP (constant prices yoy %)	7.6	2.1	-15.1	3.0	4.0
Private Consumption, real, yoy (%)	17.1	11.6	-14.2	0.5	3.0
Fixed Investment, real, yoy (%)	24.8	4.2	-46.2	8.0	14.0
Public Consumption, real, yoy (%)	2.8	-0.4	-8.8	1.5	0.7
Exports, real, yoy (%)	2.8	6.7	-25.6	10.0	9.0
Imports, real, yoy (%)	20.2	17.5	-38.6	8.0	10.0
CPI (average, yoy %)	12.8	25.2	16.0	9.6	11.5
Central bank reference rate	8.00	12.00	10.25	9.50	9.75
Monthly wage, nominal (EUR)	195	234	170	223	286
Unemployment rate (%)	6.4	6.4	8.8	7.2	6.4
Budget balance (% of GDP)	-1.4	-1.3	-11.3	-6.1	-3.8
Current account balance (EUR bn)	-4.0	-8.8	-1.4	0.2	-0.8
Current account balance (% of GDP)	-3.9	-7.1	-1.7	0.1	-0.5
Net FDI (EUR bn)	6.3	7.3	3.2	4.9	7.5
FDI (% of GDP)	6.1	5.9	3.9	4.3	4.8
Gross foreign debt (EUR bn)	56.2	75.1	72.6	90.7	95.0
Gross foreign debt (% of GDP)	54.6	60.8	89.1	79.1	60.5
FX reserves (EUR bn)	21.6	19.9	17.9	21.1	16.1
(Cur.Acc-FDI)/GDP (%)	2.2	-1.2	2.2	4.4	4.3
FX reserves/Gross foreign debt (%)	38.4	26.6	24.7	23.3	17.0
Exchange rate to USD eop	5.09	7.81	8.01	7.40	6.90
Exchange rate to EUR eop	7.42	10.90	11.48	9.03	8.56
Exchange rate to USD avg	5.05	5.24	8.06	7.83	7.15
Exchange rate to EUR avg	6.92	7.70	11.24	9.87	8.65

Source: UniCredit Research

STRENGTHS

- Improving C/A balance, and better export performance
- Significant NBU FX reserves
- Significant spare capacity

WEAKNESSES

- Lack of reform and fiscal consolidation
- Upcoming local elections
- Divided society

First local elections, then reforms

Immediate growth driven by exports

Immediate growth prospects continue to be driven by exports and base effects (with Ukraine witnessing 4.8% yoy growth – one of the fastest rates in the CEE region in 1Q10). In the coming quarters acceleration of EURO2012 infrastructure projects may give an additional boost to growth, however, financing still remains an issue. A more robust recovery of private consumption and investment continues to be limited by low credit activity (as the banking system as a whole continues to deleverage) and high interest rates. Although unemployment has started to fall sharply, according to official statistics, real wages have been growing by an average 6% since the start of 2010, which is starting to feed gradually into the still sluggish retail trade dynamics (YTD +1.1%) – but it will take another 3 to 4 quarters before we see a more sustainable consumption rate. We see GDP growth reaching its long-term potential of 5% by 2012, however at the same time are concerned that lack of reform will bring this potential down to 3%, which represents a key risk to our already below consensus forecast.

But reform key to reaching long-term 5% growth potential

In the run-up to the local election, we see little interest in reform

During the summer months we see little interest in the country towards implementing painful reforms (tariff hikes, pension reform) as we approach regional elections, which are most likely to be set for October 2010 (when the Party of the Regions hopes to further consolidate its hold on power at local level). We believe that in the run up to the elections the government is set to maintain the status quo, despite the economy benefiting from the export-led recovery. The recent USD 2bn loan from Russia, postpones the need for an IMF program, which will likely include upfront reform conditions and tough negotiations this time. By this token a resumption of the program may be feasible after the elections in Nov-Dec 2010, unless there is a change in direction towards quicker reform in the meantime.

USD 2bn loan from Russia eases immediate financing needs

FX intervention is building a buffer of stability

In such an environment the Central Bank is set to continue building an FX buffer and keeping the USD/UAH rate stable at 7.91, further intervening on the FX market (the NBU bought some USD 3.3bn on the market in Mar-May 2010), amid ongoing capital inflows. We expect this to continue well into the year-end when some potential appreciation may be allowed – this is based on C/A remaining in surplus and FDI inflows remaining robust (4.3% of GDP in 2010). The main risk to the benign FX outlook may come from lax fiscal policy that could in the end push for monetization and lead to local confidence deterioration.

But with NBU still the chief financier of the government, but money not spilling through on the market so far

In the current environment the National Bank continues to be the chief financier of the government, buying 60% of the T-Bills issued in February onwards (UAH 11bn), whereas non-residents bumped up their exposure by UAH 2.6bn, bringing their total exposure to UAH 3.1bn (3% of the total issues outstanding). However, the government is now aiming to diversify its sources of financing with a Eurobond worth USD 1.3bn planned in the coming months and a USD 2bn loan from Russia agreed upon. In principle this has reduced the funding need for the summer months. But the optimism that markets have placed in the new government still needs to be confirmed - yields on T-Bills came down from 20%-25% in February to the current 11%-15%, while these are set to rise on the upcoming issuance of VAT bonds worth UAH 20bn.

So far this year inflation has trended downwards and we have nudged our average forecast lower to 9.6% amid lack of domestic demand, but M0 and M3 have started to grow, which is a sign that economic recovery is underway, but also a risk that any abrupt monetization could lead to acceleration in the inflation rate as favorable base effects disappear from Sept onwards. By the same token producer prices have continued to grow by double digits – signaling a lack of competition and the need for further liberalization by the government.