DESK – NOTE

Ukraine's economy: Bracing for a bumpy ride

Despite a laudable 5.2% Y-o-Y performance in 2011, challenging global economic environment already placed Ukraine's economy on a path of weaker growth that is very likely to prevail throughout this year. Confidence crisis and uncertainty on international financial markets continued to dampen economic activity worldwide, increasingly spilling over to the domestic economy through trade and financial channels. Thus far, the pattern and pace of growth remain on course of "No shocks" scenario, although we continue to see signs of weakness both in the export-oriented and (to a lesser extent) in the domestic industries. Reduced external demand is set to keep a cap on contribution from the export-oriented sector, while domestic drivers are unlikely to provide sufficient support to keep growth on par level. Ukraine faces a difficult challenge of managing the "twin-deficit' problem. With these in mind, we maintain our cautious outlook on growth in 2012.

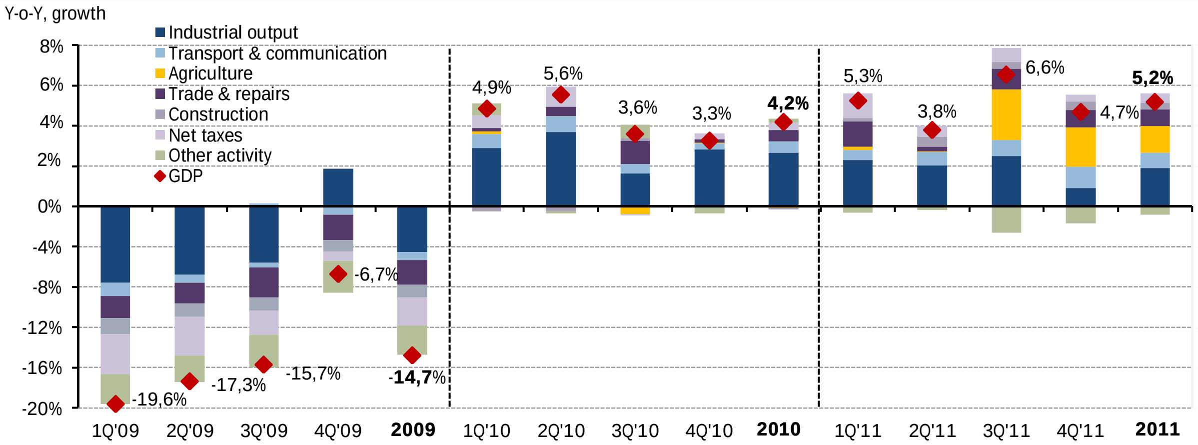
Excerpts from scenarios	2012 'No shocks' scenario	2012 'Depressed growth' scenario
Real GDP growth, %	3.8	0.9
Nominal GDP, UAH bn	1500.3	1471.7

Source: AYA calculations and estimates

Official data confirmed that Ukraine's economy expanded by a robust 5.2% Y-o-Y in 2011 despite a slowdown at the end of the year. After a weakening of external demand, domestically-driven industries overtook the baton of support, led by agriculture, trade, transportation and construction.

Deteriorating global economic conditions have started to take a toll on Ukraine's economy since the fall of 2011, translating into a slowing pace of growth in the final quarter of 2011 which persists till present. At a time when the economy's main growth engine – the manufacturing industries – lost steam, agriculture and trade provided support to economic activity. The latter industries contributed collectively 3.5% (percentage points) out of the 6.6% Y-o-Y growth rate in the 3Q'11 and 2.8% (percentage points) out of 4.7% Y-o-Y growth in 4Q'12. Yet, needless to say that without the record-setting harvest year for the agriculture sector, growth would have been significantly softer.

Domestically-oriented industries were the principal growth drivers in 2011



Source: SSC, AYA estimates and calculations

The global economic slowdown has fed into Ukraine's economy through two primary transmission channels that tend to reinforce each other: financial and economic. On the one hand, contagion fears in the Eurozone amid bank deleveraging increased risk aversion and led to reduced and costlier access to external financing for Ukrainian borrowers. On the other hand, Eurozone recession and slowing growth abroad resulted in weaker external demand for Ukraine's exports and lower prices for key export items (shown on chart below).

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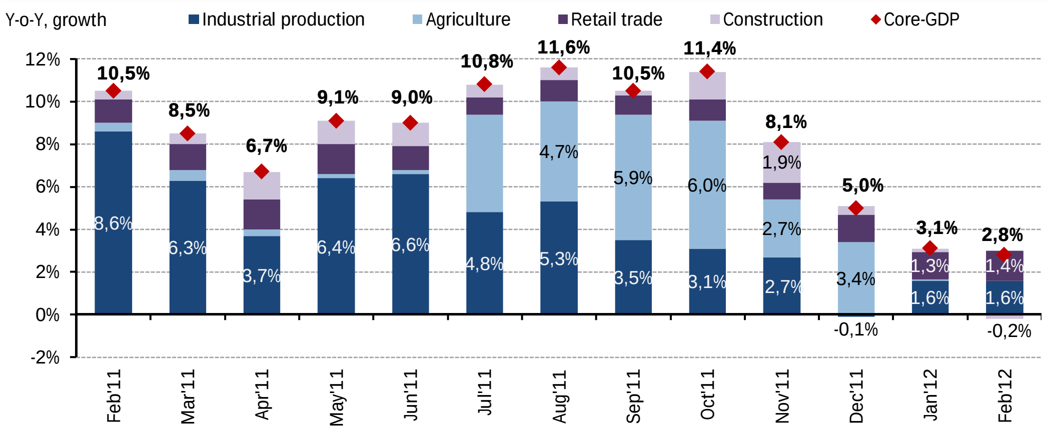
Deceleration of growth in core industries implies lower GDP growth in 1Q'12

In the first months of 2012 Ukraine's economy continued to march along the 'weak growth path', as deteriorating external demand undermined economic performance. **The economy's key industries continued to demonstrate signs of softness, which we expect to translate into weak GDP growth in the 1Q'12.** The NBU's 'core-GDP'[1] data reveal a marked slowdown in economic activity, primarily stemming from industrial production which is highly dependent on demand conditions in our key export markets – Russia, Eurozone, Turkey. Meanwhile, **the fading 'agriculture effect' further depressed growth figures.**

At this juncture, the economy appears to be hanging in the balance between following our "no shocks" and "depressed growth" scenarios due to the prevailing uncertainty of the global economic prospects. Yet, domestic themes remain largely unchanged. **In 2012 we are inclined to see a significant weakening in Ukraine's main growth engine (export-oriented manufacturing industries) and as a consequence expect growth to be primarily a function of internal demand.**

Core-GDP figures point to weaker GDP growth in 1Q'12 as industrial production underperforms and 'agriculture effect' fades...



Source: SSC, NBU, AYA estimates and calculations

[1] **'Core-GDP'** is an aggregated index (of production in basic industries) developed by the National Bank of Ukraine to track output performance of the economy's basic industries: agriculture, manufacturing, mining & quarrying, trade and construction

Yet, in our view, it is ***unlikely that internally-driven industries will completely substitute for the diminished external drivers, which should result in sub-par growth in 2012***. The IMF has already lowered its growth forecast for Ukraine from 4.8% (Oct'11) to 3.0% (Apr'12) in 2012.

Amid weak external economic background and volatile financial markets, Ukraine also faces a difficult challenge of managing **the 'twin deficit problem'** – deficits on the balance of payments and the general government balance. This problem is the **key potential source of risk to economic performance and macroeconomic stability in 2012**. In our view the key to its successful resolution lies in finding a source of financing that would facilitate funding needs, while the intensity of the need for such source will be determined by external economic background. We discuss the ability of the government to address these challenges and procure financing in our respective desk-note (*BoP and FX: Is this time different?*) and the recent Quarterly Economic Overview[2].

Twin-deficit problem poses key threat to economic performance and stability

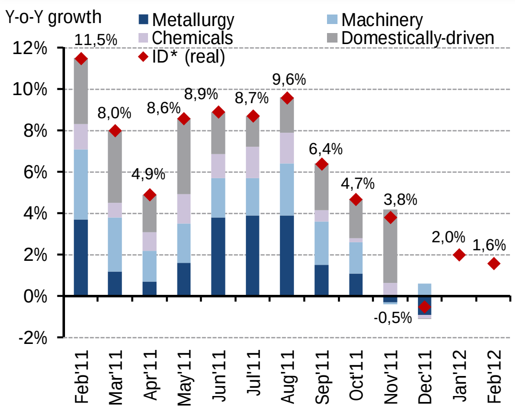
Below, we assess the overall economic performance by dissecting the GDP into potential growth-contributors (detractors), examining the outlook for each and providing an updated view on their aggregate contribution to economic performance. The analysis below follows our baseline – "no shocks" scenario – as we continue to believe that in spite of disruptions in the Eurozone, modest global economic expansion will prevail, pulled by the developing countries (China in particular), and possibly the US.

Industrial production

It is highly indicative that industrial production, accounting for approximately 40% of Ukraine's annual real output, is set, in our view, to demonstrate the greatest weakness. The key to our subdued view on the prospects lies in the composition and final destination of industrial output. Metallurgy and machinery have been the champions of industrial growth (as seen below), yet currently face strong headwinds owing to their largely export-dependent production. As we argued above, slower growth prospects in the key overseas markets have already undermined industrial output growth in the 1Q'12 and are likely to result in the underperformance of this segment in 2012.

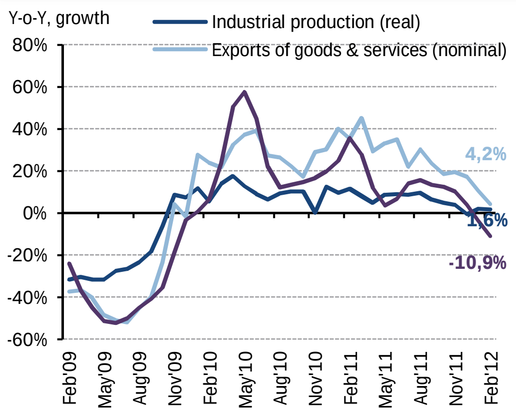
Industrial activity has the biggest potential to undermine economic growth

Industrial output performance remains heavily exposed to external business cycle



Source: SSC, NBU, AYA calculations
Note: * Industrial production

With steel market conditions play a key role in exports and industrial output dynamics



Source: SSC, NBU, CRU

[2]Macro Outlook 2012: 1Q Update (section on Public finances)

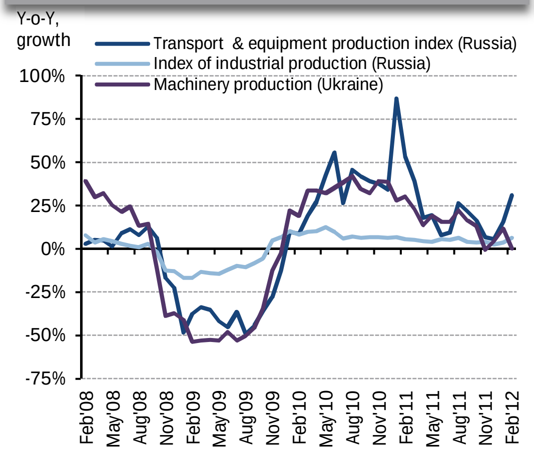
World steel and base metal market conditions remain arguably the most crucial determinant of industrial production performance and overall health of the economy. According to the IMF estimates a 10% decline in steel prices shed 1.5% percentage points off real GDP growth[3].

We expect that the outlook for the base metals market in 2012 and steel market conditions will not be conducive for Ukraine's metallurgical output growth, as the industry will be facing pressures of softening external demand, particularly in China, and largely flat price dynamics. High energy costs will also add pressure to local producers. China's economic performance is to remain crucial for the outlook of this industry. Given the deteriorating economic background, China could unroll another round of quantitative easing which should support metals prices and counterbalance lower demand from the Eurozone, but we do not expect any significant acceleration in prices.

The **outlook for machinery production also remains subdued, as both external and internal factors will weigh on its performance throughout 2012**. On the external front, we expect a weakening of demand in Ukraine's key overseas market – Russia. Weaker demand and unwound trade wars with this neighbor country are set to weigh most on the performance of the industry in 2012, given the high degree of integration between the countries' machine building industries. On the domestic front, growth rates have moderated and are likely to slow further, as tight credit conditions, reduced loan growth and the overall business cycle will be unconducive for crucial investments in the industry. Yet machinery performance could still surprise on the upside should elevated oil prices support demand from Russia.

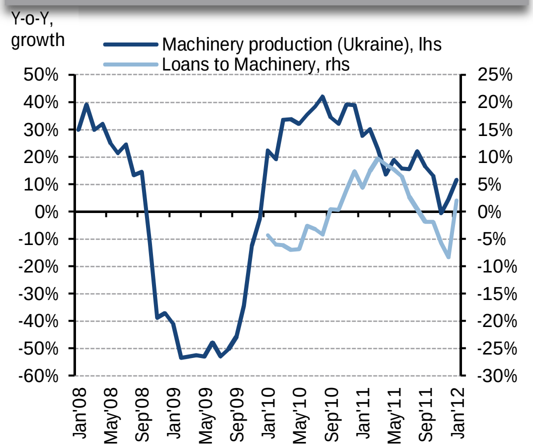
Internal and external factors point to weaker growth of machine-building

Ukraine's machinery and Russian production



Source: Russia's Federal State Statistics Service, SSC

Stalling loan growth to the machine-building industry spells weaker growth going forward



Source: SSC, NBU

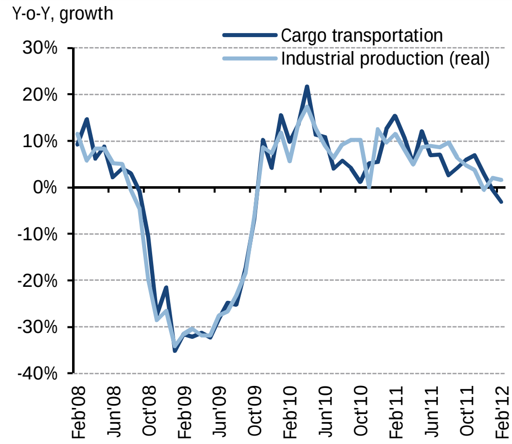
Transportation and Communication

With industrial production growth slowing, particularly in the metallurgy and machine building industries, the performance of transportation is also set to demonstrate some weakening. The sector is driven by cargo transportation and passenger traffic. The former reflects to a large extent the overall level of economic activity. Hence we expect cargo transportation to demonstrate lower growth rates on the back of the anticipated weaker industrial activity. At the same time, we expect the passenger transportation to outperform cargo and peek in the end of the 1H'12 as demand for transportation will benefit from an influx of foreign visitors. However, the contribution from this sector is likely to remain capped at c.0.5% according to our expectations.

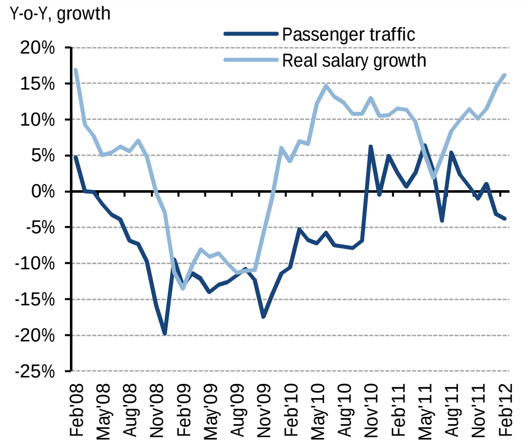
Weaker economic activity is likely to reflect on slower growth in cargo transportation, while the passenger segment is set for growth

[3] Ukraine: selected issues (IMF, 2008)

Cargo transportation depends heavily on the level of activity in the industrial sector



While passenger traffic turnover appears to be influenced by real salaries



Source: State Statistics Committee, AYA calculations

Wholesale and retail trade

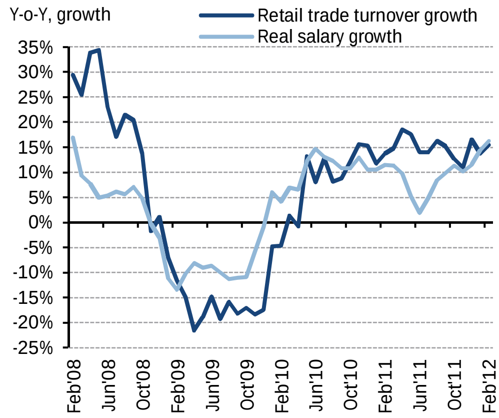
Wholesale and retail trade has thus far been one of the few resilient segments, providing support to the overall economic activity as other traditional growth drivers suffered. The year-end holiday-induced spending contributed to a pick-up in growth within this sector in the final month of 2011, while slowing dynamics at the beginning of the year mostly reflected a mixture of post-holiday slackening and lower confidence levels. In our view, this segment may turn out to be among the major growth-stimulatory engines and leading contributors to growth throughout 2012, provided the economy stays on the "no shocks" course. **We see a number of growth-supportive factors in this segment, such as continued presence of banks in lending, a boost to demand from the Euro-2012 visitors, and possible pre-election fiscal handouts**. To date, banks have been very supportive for economic activity within this sector owing to mostly short-term nature of lending and high effective interest rates. In fact, short-term consumer lending has thus far demonstrated one of the highest growth rates in the banking sector.

We expect wholesale and retail trade to be among leading contributors to growth in 2012

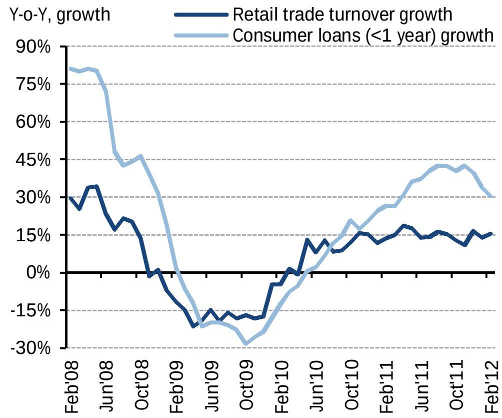
In light of the macroeconomic risks and deleveraging in other sectors such as commercial and residential real estate, we **expect consumer lending to remain among the most attractive sources of income for banks, and we anticipate further expansion in banking activity on this front, particularly in cash-financing**. Consumer cash-financing has been one of the most widespread banking products in the 2H'11, while a number of banks have mentioned this business segment as one of the priorities for their revenues in 2012.

In our view, the bulk part of growth should come in the Q2 and Q3, as the European tournament finals take place, while inflation has not yet squeezed real incomes. Moreover, as the pre-election campaign takes off, we are likely to see a return of fiscal populism and an increase in social expenditures, which should further support activity in wholesale and retail trade. At the same time, we are cautious about a risk of higher inflation which should pressure real growth in this segment's in 2H'12.

Real salary growth and active consumer financing by banks have been supportive to retail trade



Source: State Statistics Committee, AYA calculations



Source: State Statistics Committee, NBU, AYA calculations

Agriculture

Recent weather conditions have undermined the potential contribution of the agrisector

The performance of the agriculture sector is perhaps the most difficult to project given its high dependence on the state of weather conditions. As can be seen on the graph at the beginning of this section, the contribution of the agriculture sector to GDP growth has been quite erratic in 2009-2011, with most contribution coming in the Q3'11. What can be said with reasonable probability is that the autumn dry spell and cold weather conditions in Jan'12 have most likely damaged winter crops. That should translate into a marginal contribution from this sector in the 1H'12. The extent of the support to growth from agriculture throughout the year, and particularly in the 2H'12 will be crucially dependent on the weather conditions and crop harvest during the mentioned period. However, we are of the view that **the repeat of the 2011 record harvest is highly unlikely and therefore we do not expect a similar contribution from the agriculture sector in 2012**.

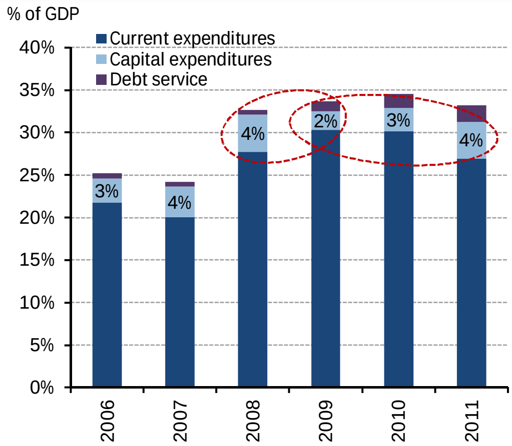
Construction

Social spending is likely to crowd out capital expenditures

While deleveraging in the private sector limits its capacity for contribution to growth

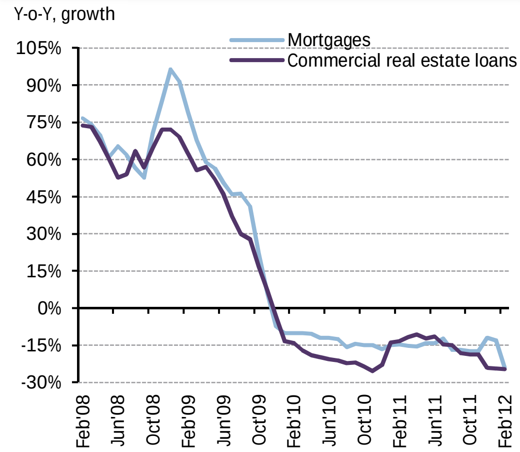
The segment has provided modest contribution to growth in the post-crisis period, while the recent growth rates were largely public sector driven. Infrastructure projects, related to the hosting of the Euro-2012 championship (stadiums, hotels, roads, airports) have been the core beneficiaries of the government's capital expenditures and hence were the key contributors to growth within the sector. However, we remain bearish in our view on the prospects for construction sector in 2012 as the recent support factors are unlikely to stay, while the fundamentals remain unchanged. The bulk part of the major infrastructure projects has been completed as construction entered the final stages with almost a month left until the start of the tournament. Moreover, we believe that the government is unlikely to invest on the same scale in infrastructure in 2H'12. We believe that **the need to focus on social spending ahead of the parliamentary elections will take precedence and is likely to crowd out capital expenditures**. Given the consumption-oriented structure of budget expenditures and obvious financing constraints of the government, the tradeoff is likely to be made in favour of social spending. At the same time, the private sector continues to deleverage and mortgage loans continue to contract. Thus, we believe that the private sector is unlikely to make a contribution with residential housing still in the doldrums following the recession. In the meantime, higher interest costs and scarcer credit availability due to stricter borrower-screening process deter expansion of activity in this area.

Public capital expenditures are unlikely to contribute on the same scale in light of spending trade-offs



Source: Treasury, MoF, SSC, AYA estimates and calculations

While ongoing deleveraging in the private sector is likely to stunt its ability to contribute to growth



Source: NBU, AYA estimates and calculations

Conclusion

Overall, taking into account the outlook for each of the abovementioned sectors, we come to the conclusion that Ukraine's growth path remains on a weaker footing. Risks to growth and macroeconomic stability are plentiful, stemming largely from the transmission and impact of external shocks abroad. At this juncture, growth has softened, but provided the economy follows our "no shocks" scenario, we expect economic activity to pick-up moderately throughout the year. Growth will largely stem from the internally-driven sectors such as wholesale and retail trade, food processing and possibly transportation. Meanwhile, the rise in oil prices may partially support external demand for Ukraine's products from Russia and the Middle East.

In case the assumptions of our "depressed growth" scenario materialize, we expect significant weaknesses across all industries, with domestic-oriented segments somewhat resilient, yet still insufficient to drive growth. Overall, growth should be modest, bordering on contraction, as external shocks will weigh on Ukraine's economic activity and increase macroeconomic and financial risks.

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