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Focus Notes: Ukraine

Resumption of the IMF lending is pending due to concerns over 2010 budget deficit

- ✓ Reports suggest that a **new \$19-20bn loan programme of 2.5 years (2010-2012) is under discussion between Ukraine's authorities and the IMF**. An IMF mission was expected to arrive to Kiev on May 17, for further talks, but the trip has been postponed due to uncertainty over the government's ability to keep the budget deficit under control. The Fund has **concerns on the situation with Naftogaz and energy reforms** as well as on the progress in the pension system. Namely, two areas for reduction in current expenditures pointed out by the IMF in the previous program were left largely untouched by Polish authorities when drafting the 2010 budget target. On one hand, the government did not cancel the increase in minimum social standards passed by the previous administration and instead allocated UAH21.8bn or 2% of GDP in the 2010 budget for this purpose. On the other hand, little progress has been made on reforms to generous gas subsidies – a key factor for resumption of IMF lending. Although the IMF recognised the good news on growth (coming from the Q1-10 GDP reading) it is clear that negotiations will be tough. In our assessment, **the IMF programme will be approved but it might be delayed**. Any delay is not in favour of Ukrainian assets. If a deal with the IMF is not reached any time soon, the markets' confidence in the new administration may well start to fade, risking a substantial sell-off.
- ✓ Ukraine's economy grew by an impressive **4.8% yoy in Q1-2010** from a 6.8% yoy decline in Q4-09. Real GDP growth returned to positive territory **after five consecutive quarters of contraction**. The economic recovery is driven by a substantial rebound in exports (they grew by 24.2% yoy in Q1-10 from a rise of 3.2% yoy in Q4-09) on the back of stronger external demand for steel coupled with favourable base effects. Industrial production rose to 17.4% yoy in April from 13.8% yoy increase in March, beating consensus of 14.0% yoy (last April's reading for industrial production was -31.8% yoy). We expect a rebound in Ukraine's industrial production.

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Note that, industrial production accounts for nearly a quarter of Ukrainian GDP. On the other hand, domestic demand remains weak; however it is expected to start recovering in H2-2010 as conditions for consumers have shown signs of improvement. The annual pace of decline in retail sales has eased further; it stood at -2.7% yoy in April 2010 from -3.1% yoy recorded in the previous month and from -20.6% yoy posted in December 2009. In addition, real wages returned to positive territory since the beginning of this year, although this partly reflects the falling inflation. Wage growth stood at 14.8% yoy in April 2010 compared to 5.5% yoy in December 2009. All in all, we forecast a GDP growth of 2.5% yoy in 2010 on the back of uncertainty regarding the Eurozone growth (given Ukraine's high trade openness), still subdued domestic demand and absence of room for fiscal stimulus.

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