SigmaBleyzer

Ukraine
Macroeconomic Situation

December 2007

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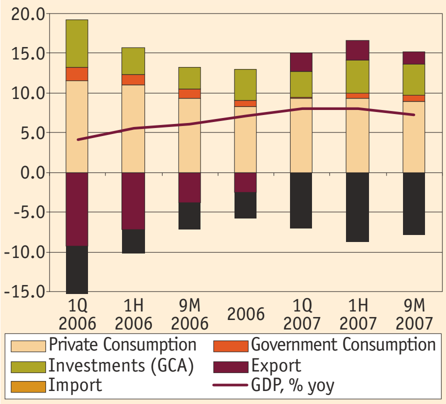
Summary

- Underpinned by robust domestic demand and a benign external environment, the Ukrainian economy grew by a real 7.2% yoy over January-November and is expected to post above 7% yoy growth for the entire year.
- Fiscal performance has remained solid; the consolidated budget posted a surplus of about 1% of January-November GDP. However, despite the current fiscal surplus, we expect considerable fiscal loosening in December, causing a deficit of about 2% of GDP.
- In the last few days of December, the Ukrainian parliament adopted the 2008 state budget law, calling for a 2.1% of GDP deficit. Generous social payments (including the prime minister's intentions to repay about UAH 20 billion of depreciated Soviet era savings) and a rather ambitious target for budget revenue growth make the 2008 fiscal outlook rather uncertain.
- Planned increases in pension benefits in the 2008 budget law would inflate State Pension Fund expenditures by about 40% yoy. Although de jure the State Pension Fund will remain balanced, the burden of pension liabilities for the state budget will increase to 3.7% of forecast GDP. This calls for urgent acceleration of pension reform.
- Advancing by 15.2% yoy in November, year-end consumer inflation promises to be the highest in seven years. The NBU has been taking measures to curb robust growth of monetary aggregates. However, considering the anticipated fiscal loosening at the end of the year, more aggressive efforts may be needed to contain inflationary pressures at the beginning of 2008.
- Despite slight deceleration, Ukraine's export performance remained strong over the first ten months of the year. At the same time, acceleration of imports growth contributed to further widening of the merchandise trade deficit.

Economic Growth

2007 was another year of impressive real growth performance for Ukraine despite a number of challenges, including a 37% increase in imported natural gas prices, high world crude oil and other commodities prices, and political instability. Nevertheless, the Ukrainian economy posted a 7.2% yoy real increase in GDP over January-November and is expected to grow above 7% yoy for the whole year. Economic growth was underpinned by robust domestic demand as well as a benign external environment. Since 2004, household consumption has become the primary engine of economic growth. Driven by double-digit real wage growth, procyclical expansionary fiscal policy and a continuing domestic credit boom, private consumption grew by a strong 15.2% yoy over the first nine months (9M) of 2007. Driven by the growing need to renovate existing production capacities and introduce energy saving technologies due to rising energy and other input costs (as well as tightening competition on both domestic and external markets), fixed investments grew by a remarkable 21.8% yoy over 9M 2007. A favorable external environment supported Ukrainian exports, which grew by 3.1% yoy over the period (export of goods and services reported a decline of almost 7% yoy in 9M 2006). On the downside, buoyant domestic demand fueled an impressive growth in imports, which accelerated to 15.4% yoy.

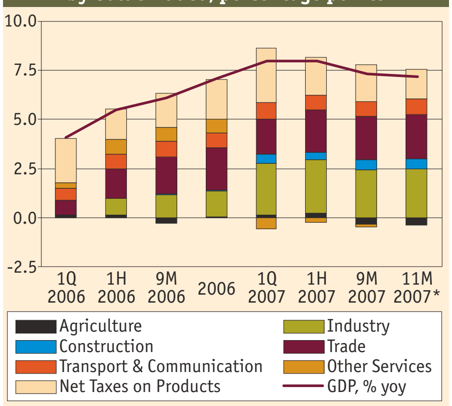
Contributions to Real GDP Growth by Expenditure, percentage points



Source: State Statistics Committee, The Bleyzer Foundation

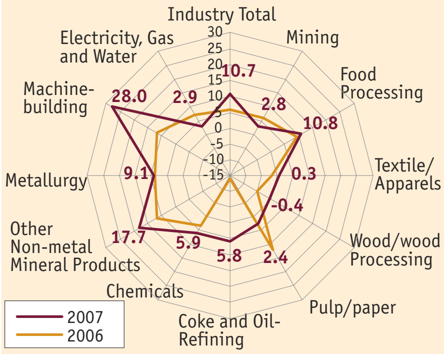
On the supply side of the economy, GDP growth was supported by further expansion of value added in wholesale and retail trade, manufacturing, construction and transport. In particular, value added growth in wholesale and retail trade kept increasing and reached 17.4% yoy over January-November. Though value added in manufacturing slightly decelerated, which is partly attributed to a high statistical base effect, it reported decent 12.9% yoy growth. Accounting for less than 1/3 of total value added, manufacturing and domestic trade together explained almost 2/3 of GDP growth in January-November 2007. Growing real household disposable income, healthy growth in industry and expanding trade encouraged a 7.2% yoy value added increase in transport. Strong business activity, rising income and availability of credits supported a 11.3% yoy increase in construction. Good performance in industry and service sectors contrasts with a continuing decline in agriculture. In January-November, value added in agriculture decreased by 5.2% yoy. Droughty weather conditions and structural changes in agriculture were the main reasons for poor agricultural performance in 2007. However, due to its declining share in total GDP (about 7%), the negative developments in this sector had a relatively small impact on overall economic growth.

Contributions to Real GDP Growth by Value Added, percentage points



* Estimates based on operative statistics
Source: State Statistics Committee, The Bleyzer Foundation

Industrial Output by Industries in January-November, % yoy cumulative



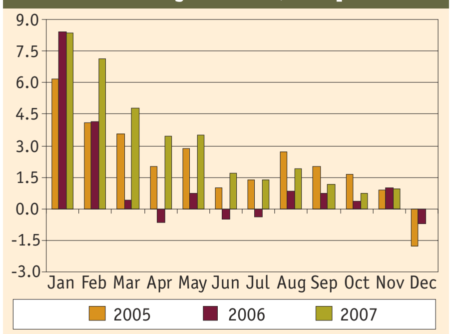
Source: State Statistics Committee

A shortfall in agriculture contributed to a notable slowdown in food processing output to 10.8% yoy in January-November, compared to 12.1% yoy in the first ten months of the year and 14% yoy in January-August. Stagnating world steel prices and a higher statistical base effect contributed to the slower pace of growth in metallurgy (9.1% yoy in January-November vs. 9.9% yoy in the first ten months of 2007). In addition to the above reasons, the deceleration in metallurgy may also be explained by the shortage of coking coal, a result of a number of accidents in Zasiadko mine during November. Indeed, extraction of fossil fuels declined by 2% yoy, driven by a 3.1% yoy decrease in extraction of coal and peat. At the same time, high world iron ore prices stimulated domestic ore extraction, which expanded by 6.6% yoy in January-November. As a result, total output in the mining industry decelerated marginally to 2.8% yoy. On the upside, chemical and machine-building industries continued their strong expansion. Output in machine-building grew by an impressive 28% yoy, driven by growing population income, buoyant domestic and external investment demand. The export-oriented chemical industry benefited from rising international fertilizer prices. In addition, in anticipation of higher natural gas prices in 2008, chemical enterprises may also invest in make-to-stock production. Meanwhile, output of chemicals grew by almost 6% yoy, accelerating from 5.2% yoy in January-October. Acceleration in these industries, however, did not compensate for the slowdown in metallurgy, food processing and extractive industries. As a result, total industrial output growth decelerated to 10.7% yoy over January-November. Considering that metallurgy will keep experiencing the shortage of coking coal, food processing and mining will be affected by poor agricultural and coke-extraction performances as well as the presence of the high statistical base effect, industrial output growth may continue to slow in December. However, it is expected to stay above 10% yoy, which will still be a notable acceleration from 6.2% yoy last year.

Fiscal Policy

Fiscal performance has remained solid, supported by higher than expected rates of economic growth. In January-November, the consolidated budget posted a surplus of about 1% of period GDP. Over the period, consolidated budget revenues grew by a nominal 28.2% yoy to reach UAH 195.1 billion ($38.6 billion). Fiscal authorities were able to over-fulfill revenue collections thanks to buoyant economic activity. In particular, receipts of personal income tax (PIT) grew by an impressive 52.4% yoy over the period thanks to faster than expected wage growth and a rise in the PIT rate to 15% at the beginning of 2007, up from the previous 13%. Ample proceeds allowed the personal income tax to become the second largest source of consolidated budget revenues, replacing corporate profit tax[1], though collections of the latter grew by a strong 32% yoy. At the same time, VAT receipts remained the major contributor to consolidated budget revenues. Collections from VAT grew by 18.2% yoy over January-November, up from 17.6% yoy in January-October. Despite an improvement in VAT collections, their rate of growth can be considered rather moderate, considering double-digit real growth in domestic trade, industry, construction, and higher than expected inflation.

Consolidated Budget Balance, % of period GDP



Source: Ministry of Finance

At the same time, the relatively high fiscal surplus for the period was generated mainly due to under-execution of consolidated budget expenditures. According to the State Treasury report, expenditures from the general fund of the state budget were 4.5% below the January-November target. The data suggests that about 15% of the total consolidated budget expenditures planned for 2007 should be executed during the last month of the year. The situation when government authorities keep surpluses during the majority of the year through under-execution of expenditures and over-fulfill expenditures in the last month of the year is quite typical for Ukraine. Hence, if fully exercised, the hike in expenditures in December is likely to be the most severe this year. Considerable cash balances, accumulated on the government accounts thanks to robust growth in budget revenues and under-fulfillment of expenditures over the first eleven months of the year, may allow the government to fully meet its expenditure commitments. At the same time, execution of consolidated budgets in the last several years signifies that not all transactions are settled in December. As Ukraine follows international standards compiling government finance statistics on a cash rather than accrual basis, the fiscal deficit may be lower than that targeted in the budget law. Indeed, in 2005 and 2006, consolidated budget expenditures remained under-executed by about 5%. Given the current rate of budget execution, it is reasonable to assume that 2007 will not be any different from previous years. Thanks also to higher than expected nominal GDP, we anticipate the year-end fiscal deficit to be below 2% of GDP.

Due to early parliamentary elections and the prolonged formation of a governing coalition, there was a risk that the country would enter 2008 without a budget. However, in the last days of December, the government presented a slightly revised draft budget for 2008, which was quickly approved by the parliament. In particular, the 2008 state budget calls for a deficit of UAH 18.5 billion ($3.7 billion), which is equivalent to 2.1% of forecasted GDP. The state budget was based on GDP growth of 6.8%, consumer inflation of 9.6% at the end of the year, with fiscal revenues estimated to increase by about 36.5% yoy in nominal terms. Though the official forecast of real GDP growth in 2008 looks overly optimistic, nominal GDP may turn out to be realistic considering that inflation is likely to be higher. Nevertheless, the targeted budget revenues may be hard to achieve considering the expected slowdown of economic activity in 2008, affected by higher input costs (particularly energy and labor), the likely deceleration of credit growth and a less favorable external environment. The government expects to achieve extra revenues from the formalizing of the shadow economy and improving tax administration. For these plans to materialize, the government needs to accelerate structural reforms in the country, which may be a difficult task considering the approaching presidential elections and the thin majority in the parliament.

On the expenditure side, 2008 will be another year with a heavily socially-oriented budget. In particular, it envisages an increase in living/minimum wages at higher rates than in the previous year, measures to increase differentiation of pension payments, notably higher stipends, payments for childbirth, social benefits for invalids and others. Thus, the average wage is forecasted to increase by a real 18.7% yoy. Generous pension initiatives of the government will result in a 40% yoy increase in total Pension Fund expenditures, according to Prime Minister Yulia Tymoshenko. Though de jure the State Pension Fund (SPF) will be balanced, de facto the balance will be achieved thanks to higher transfers from the state budget. According to the Budget Law, transfers to the SPF in 2008 will grow by about UAH 10 billion compared to the previous year and will reach 3.7% of forecasted GDP. The pay-as-you-go pension system inherited from Soviet era, with a rather low pension age (60 years for men and 55 years for women), generous early eligibility and other privileges, requires urgent reforming. In 2004, transition to the three-pillar pension system was initiated. However, due to the lack of political will during the turbulent 2004–2007 period, so far the only significant achievement is the establishment of the third tier of the pension system — private pension funds. A politically motivated decision in the run up to the 2004 presidential elections to raise retirees' pension benefits to the subsistence level undermined the previous efforts to strengthen the contribution-benefit link, as more than 80% of all pensioners started to receive minimum pension benefits equated to the living wage for the retirees. The proliferation of pension liabilities during 2004–2007 and announced increases in 2008 exert considerable pressure on the state budgets of the respective and the subsequent years.

Another resonant issue of the current fiscal year is the realization of election pledges of the current Prime Minister to repay depreciated Soviet era saving deposits. In 1996, depreciated savings were recognized as Ukrainian government liabilities. At that time they amounted to about 160% of GDP. Since then, however, UAH 132 billion ($26.1 billion) of depreciated saving liabilities were not indexed and thus will represent less than 15% of forecasted GDP in 2008. However, even this amount if fully repaid may shatter the macroeconomic stability of the country, already challenged by skyrocketing inflation. However, the approved 2008 state budget law envisages only UAH 8 billion ($1.6 billion) for these purposes. At the same time, the head of the government announced that above-target privatization proceeds (expected at about UAH 12 billion) will be directed to repay the depreciated savings. If realized, this may ratchet up a fiscal deficit above 3% of GDP. Though we believe that the likelihood of receiving more than UAH 20 billion ($4.1 billion) from privatization is rather low, the risk of a high budget deficit is substantial, which may negatively affect the country's economic development. Considering all of the above, the fiscal outlook for 2008 is uncertain.

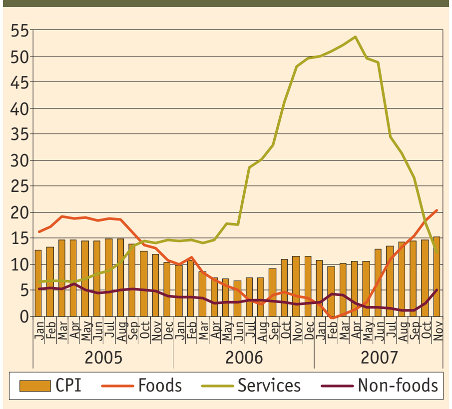
Monetary Policy

Following the surge of almost 3% month-over-month in October, the pace of consumer inflation slightly slowed, advancing by 2.3% mom in November. In annual terms, however, inflation picked up by more than 15%. Inflation was affected by both supply and demand side factors. Over the last several years, wages grew considerably faster than labor productivity, contributing to the build-up of inflationary pressures. Higher import prices on energy resources and other commodities (i.e., iron ore) fostered a 20% yoy increase in producer prices, which then spilled over into

[1] In 2006, proceeds of corporate profit and personal income taxes accounted for 13.5% and 15.5% of total consolidated budget revenues respectively.

consumer prices. On the back of high international crude oil prices, domestic and fuel prices picked up by 9.1% mom in November, which translated into almost 28% annual price growth. Though the hryvnia exchange rate with respect to the US dollar remained stable, depreciation of the latter versus other world currencies made imported goods and services from the respective countries (particularly the EU and Russia) more expensive for Ukrainian citizens and producers.

CPI by Component, % yoy

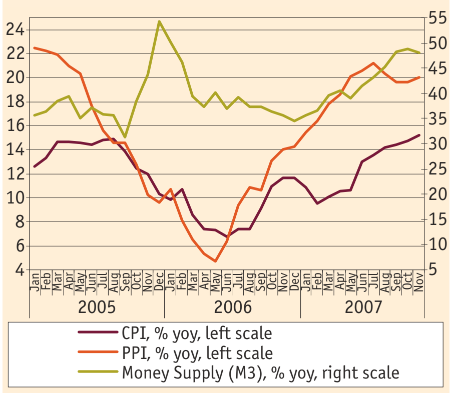


Source: State Statistics Committee

At the same time, the largest contributor to the CPI growth since June 2007 was food inflation. Foods were 20.4% more expensive in November compared to the respective months last year. In addition, foods are the weightiest component of the consumer basket, accounting for more than 50%. Such a high share of foods, which may be the result of technical deficiencies in the carrying out of household surveys (mainly the sampling procedure), makes consumer inflation biased against agricultural performance. This makes consumer price growth over-estimated in years of poor harvest and under-estimated otherwise. Although an upswing in domestic food prices was to a large extent the result of adverse weather conditions, higher fuel prices and the continuing consumption boom, acceleration of global food inflation also contributed to the food price increase. As inflation pressures are unlikely to ease in December, year-end inflation in 2007 will be the highest since 2000.

Monetary expansion has added to the price swelling this year, although it was not a leading factor. Money supply (M3) grew by about 40% year-to-date (ytd) in November on the back of a 34.1% ytd increase in the monetary base. Robust growth of the monetary base was the result of accommodative monetary policy as the NBU continued to maintain the de facto peg of the hryvnia to the US dollar. As a result of the robust inflow of foreign capital, the NBU net purchase of foreign exchange amounted to $480 million in November and $7.8 billion since the beginning of the year. The purchase of foreign currency by the central bank has a direct impact on reserve money and overall liquidity in the economy. On the other hand, the impact of NBU interventions on the monetary base was partially compensated for by sterilization operations and accumulation of budget funds (due to under-fulfillment of budget expenditures). In particular, the NBU intensified its sterilization activity in November by selling UAH 20 billion worth of certificates of deposit, while cash balances on government accounts grew by 67.4% over January-November. However, considerable fiscal loosening expected in the last month of the year will spur further expansion of monetary aggregates and will require more aggressive measures to curb money growth in the short run.

CPI, PPI and Money Supply Developments



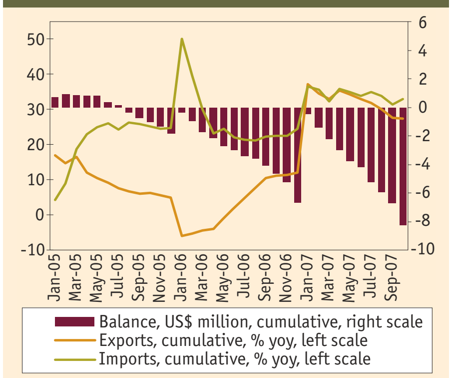
Source: State Statistics Committee, The Bleyzer Foundation

High money supply growth was also associated with strong growth of commercial bank loans to the private sector, which picked up by an impressive 74.2% yoy in November. Since 2001, credit growth has exceeded 55% per annum. Though the long-lasting credit boom is responsible for the rapid expansion of the Ukrainian economy (by about 7.5% yoy per annum over 2001–2007), such a rapid increase in credit contributed to the erosion of the current account balance from high surpluses in 2001–2005 to moderate but widening deficits in 2006–2007. To expand their credit portfolios, commercial banks have increasingly relied on external borrowing. This resulted in growing external indebtedness and the dollarization of the economy as foreign currency denominated loans accounted for more than half of total credit stock. To reduce the vulnerability of the banking system to possible exchange rate risks, the National Bank of Ukraine introduced reserve requirements in mid-November on funds attracted by commercial banks from abroad. These measures, as well as the ongoing global credit squeeze, may lead to a deceleration of domestic credit growth in the coming year.

International Trade and Capital

Favorable price developments for steel, agricultural and other commodities on the international markets as well as buoyant investment demand in -Ukraine's main trading partner countries benefited Ukrainian exports. The fall in global cereal production due to adverse weather conditions and a shift in the crop structure towards bio-fuel on the back of growing demand from emerging markets (particularly China and India) stimulated Ukrainian exports of agricultural and food products, which were up by about 32% yoy and 46.3% yoy in January-October respectively. An increase in agricultural exports could have been even higher, considering that due to the presence of quotas, grain exports declined by 40% yoy over the period. On the back of high world prices on ores, coal and fertilizers, exports of mineral and chemical products advanced by 8.2% yoy and 17.5% yoy respectively. Due to stabilization of world steel prices and an increased statistical base effect, the growth of metallurgical exports decelerated but remained at a decent 27.4% yoy. A higher statistical base was also responsible for the slowdown in export of machinery and transport equipment. However, despite deceleration, exports of this commodity group grew the most dynamically, reporting a 54.2% yoy increase over the first ten months of the year. Since metallurgical products, machinery and transport equipment together account for almost 60% of total merchandise exports, the growth slowdown in export of these commodities caused slight deceleration of total exports. Over January-October, Ukraine's merchandise export grew by 27.4% yoy (down from 27.6% yoy in January-September) to almost $40 billion.

Merchandise Trade Performance



Source: State Statistics Committee

While exports continued to demonstrate moderate deceleration, CIF imports advanced by 33% yoy over the period (up from 31.5% yoy in the first nine months of 2007) to $48.2 billion. The growth of imports was underpinned by higher prices of energy resources, rising international prices of other commodities, and buoyant growth of domestic consumption supported by the continuing credit boom. As the growth of imports outpaced exports FOB/CIF merchandise trade balance continued to deteriorate, reaching $8.2 billion. On the back of widening merchandise trade and income deficits, the current account deficit is expected to reach $4 billion, which is equivalent to about 3% of estimated full-year GDP. At the same time, record high FDI inflow as well as other foreign capital will more than cover the CA gap and allow further replenishment of the NBU's international reserves.

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