SigmaBleyzer

Ukraine
Macroeconomic Situation

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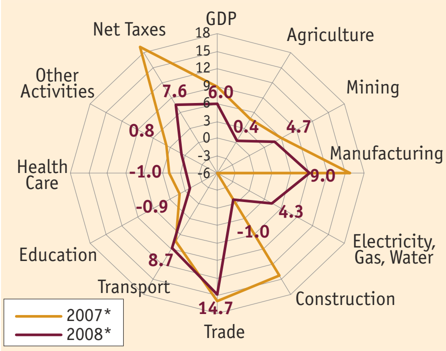
Summary

- Ukraine started 2008 with strong economic growth. Over January-March 2008, real GDP grew by 6% yoy, underpinned by vigorous value added growth in the services sector.
- Industrial production decelerated over the first three months of 2008, facing rising energy and raw materials prices as well as transportation costs.
- Despite slower economic growth and a significant rise in government social liabilities, budget execution was successful. Over January-February 2008, the consolidated budget was in surplus of 4.9% of GDP.
- Surging by an impressive 26.2% yoy in March 2008, inflation became the priority of Ukraine's macroeconomic policy. Since the end of 2007, authorities have been taking measures to reduce aggregate demand, including greater flexibility of the hryvnia exchange rate on the inter-bank market allowed by the NBU since mid-March 2008. These measures, along with the expected good harvest this year, will help to contain robust price growth.
- Booming world commodity prices and robust investment demand in Ukraine's main trading partner countries supported export growth in the first two months of 2008. However, weaker industrial production growth exacted a toll on export performance over the period. Import growth is also expected to be strong this year, contributing to further widening of the current account deficit. However, available data doesn't give an accurate account of foreign trade transactions over the first two months of the year.
- Following Ukrainian parliament ratification of WTO accession on April 10th, Ukraine may become a full member by June of this year.

Economic Growth

Following a remarkable 7.6% yoy increase of real GDP in 2007 according to the revised national accounts, Ukraine started 2008 with healthy economic growth. Real GDP growth was almost 5% yoy in January 2008 and accelerated to 6.0% yoy in January-March 2008. The growth was underpinned by robust performance of market services such as wholesale and retail trade and transport and communications. These sectors reported 14.7% yoy and 8.7% yoy increases in value added in January-March, respectively. Vigorous value added growth in these sectors was achieved thanks to buoyant consumption growth, fuelled by a continuous increase in wages and commercial bank credits. At the same time, GDP growth over the first three months of 2008 moderated compared to the previous quarter and the respective period last year. Weaker economic growth should be attributed to poor performances of construction and agricultural sectors and slower industrial sector growth.

Real GDP and Value Added Growth by Sector in January-March, % yoy



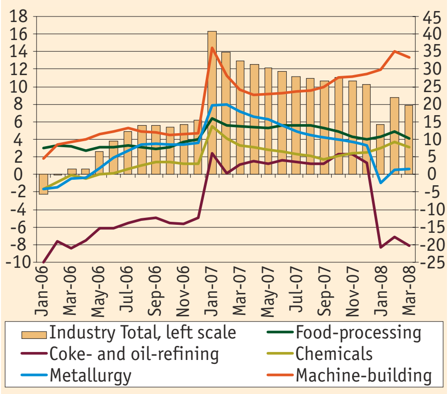
* Operative data for 2008, revised for 2007
Source: State Statistics Committee of Ukraine

Since the beginning of the year, the highly energy-intensive Ukrainian economy faced another 38% increase in the price of imported natural gas (after an almost 50% increase in 2006 and 37% in 2007). Though the increase was anticipated and the economy demonstrated strong resilience to gas price increases in previous years, the response may be more costly and longer in 2008. With the current price rise, imported natural gas will be almost three times more expensive than three years ago. Though it was long ago realized that Ukraine's import gas prices will be converging to average European levels, there was and still remains considerable uncertainty about the speed and extent of this adjustment. Eventually, the Ukrainian economy will benefit from intensified investments (including into energy saving technologies) and more efficient use of energy resources. Currently, however, the scope for raising energy efficiency is limited by delays in energy sector reforms and energy price pass-through to consumers. In addition, a benign external environment (due to rising world steel prices, robust growth in trading partner countries, improved access to external financial resources, etc.) and the continuing consumption boom helped to absorb energy price shocks in 2006-2007, while domestic demand growth is likely to moderate this year.

The poor 2007 harvest continued to exact a toll on agriculture and food processing industry performance. Over the first three months of the year, agriculture reported a meager 0.4% yoy increase in value added. Output in the food processing industry grew by 10.3% yoy over the period, slightly accelerating from 10% yoy growth in 2007. The acceleration may be attributed to strong food demand, both domestic and external (exports of foods grew by 52% yoy over January-February 2008), while shortages of agricultural products on the domestic market were partially compensated for by growing imports (particularly livestock products and vegetables). High grain and forage prices explain the continuing reduction of the livestock population (cattle and pig stock declined by 10.5% yoy and 17.7% yoy over the first two months of the year, respectively), stimulating production of meat and meat products.

In January 2008, value added in the construction sector dropped by 9.6% yoy, which may be attributed to a very high base in the corresponding period last year. Due to the unusually warm winter last year, construction works were not ceased that month as usually occurred in the previous years; as a result, the construction sector reported an impressive 26.3% yoy increase. Thanks to improved performance in February and March, the cumulative decline constituted a marginal 1% yoy over the first quarter of 2008.

Industrial Output by Selected Branches in 2006–2007, % yoy cumulative



Source: State Statistics Committee

A continuing rally of energy-producing prices on world markets as well as skyrocketing prices on raw materials, accompanied by higher transportation costs, put significant pressure on producers' input costs, thus adversely affecting productivity. Indeed, industrial output growth decelerated to 7.8% yoy in January-March 2008, down from 10.2% yoy reported for 2007. On the upside, manufacture of machinery and transport equipment reported impressive 33.3% yoy output growth, underpinned by both buoyant domestic and external demand (particularly from Russia). In addition, strong overseas demand for chemicals, particularly fertilizers, offset a surge in imported energy prices, thus supporting an almost 8% yoy output increase in the energy-intensive and heavily export-oriented chemical industry. Production of electricity posted decent 6.7% growth backed by strong energy demand amid colder winter months this year compared to the previous one and a low base affect.

Rallying international prices on iron ores inspired 4.1% yoy growth in the mining industry. At the same time, despite high demand for energy resources, domestic extraction of fossil fuels reported a modest 0.7% yoy increase mainly due to a 1.5% yoy increase in extraction of coal and peat, while domestic extraction of oil and gas declined by about 4% yoy. The latter may be explained by the existence of price regulations in the energy sector. Since the beginning of the year, the government raised rent payments on domestically extracted gas and oil and its transportation, while simultaneously reducing the maximum sale price for domestically extracted gas for selected enterprises.[1] A 40.2% yoy drop in crude oil deliveries[2], as well as planned repairs on three out of six oil-refineries, explained a 20.3% yoy decline in coke- and oil-refining industry output over January-March 2008.

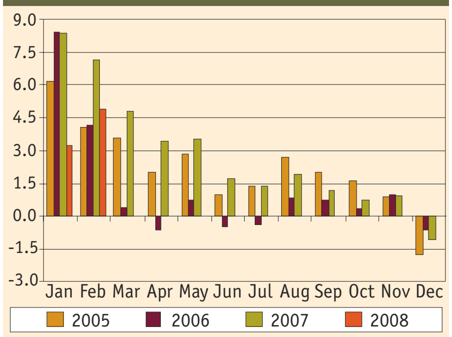
Rather unexpectedly, metallurgy reported a 2.4% decline in output production in January 2008, though the growth recovered in February and March. As a result, while world steel prices continued to pick up, Ukraine's export-oriented metallurgical production grew by 1.7% yoy over the first three months of the year. Such a modest growth over the period may be explained by a shortage of raw materials (particularly coke), planned repairs and modernization projects on several large metallurgical enterprises and a high base effect (output in metallurgy increased by 17.8% yoy over the respective period last year).

The Ukrainian government expects real GDP to grow by 6.8% yoy in 2008. A strong rise in wages and social payments (driven by loose fiscal policy), the need to renovate production capacities and introduce energy saving technologies as well as still buoyant credit growth will support domestic demand. High world prices for steel, food and other commodities will underpin exports. However, more restricted access to financial resources due to continuing financial turmoil on international markets and government authorities' measures to contain credit growth and inflation, surging energy and other commodity prices and strong imports are likely to adversely affect the pace of economic growth. Hence, we believe that growth will moderate to about 5.5% yoy in 2008.

Fiscal Policy

Despite slower GDP growth in the first two months of the year and a substantial rise in government social liabilities, Ukraine demonstrated favorable fiscal performance over the first two months of the year. In particular, the government has raised minimum and living wages by about 12-13% since the beginning of 2008 (in annual terms, they were 29% and 24% higher than in January 2007 respectively). An increase in the living wage entailed consequent upward revision of pensions, which cannot be lower than the living wage according to the Constitution. Moreover, the government initiated recalculation of pension benefits granted before 2006 based on the 2006 average wage. At the same time, the largest concerns were related to realization of pre-election promises to pay compensation for depreciated Soviet-era savings. So far, however, the government has limited payments to UAH 1000 (about $200) per each savings account holder. Although the government promised to pay compensation throughout the whole year, high inflation and political instability generated considerable public excitement. As a result, the peak of compensation payments fell in the first months of the year. As a result of all of these initiatives, current consolidated budget expenditures grew by 67.1% yoy in nominal terms, while capital expenditures grew by a modest 6.3% yoy in nominal terms over January-February. As a result, total consolidated budget expenditures rose by 65.4% yoy to UAH 34.8 billion ($6.9 billion) over the period. At the same time, a fiscal surplus of 4.9% of period GDP was recorded over January-February. This was possible thanks to typical under-execution of expenditures at the beginning of the year[3] and strong growth of fiscal revenues.

Consolidated Budget Balance, % of period GDP



Source: Ministry of Finance

During January-February 2008, consolidated budget revenues grew by a nominal 49% yoy, underpinned by a 50.1% yoy increase in tax collections, which account for about three quarters of total revenues. Growing household income, the improving financial stance of Ukrainian enterprises, booming consumption, improved tax administration and streamlined customs procedures, as well as robust import growth allowed the government to collect tax revenues above the targeted amounts. Thus, tax receipts to the general fund of the state budget were over-fulfilled by 9.4% during January-February. VAT proceeds, which increased by 53.6% yoy over the period, were the main driver of high growth of tax revenues to the consolidated budget. In addition, there is no evidence of accumulation of VAT refund arrears as VAT refunds were almost 28% above target. Plentiful corporate profit and personal income tax collections, which rose by a strong 61.3% yoy and 50.6% yoy, also contributed to successful budget execution during the first two months of 2008. At the same time, the favorable fiscal revenue outcome should be attributed to considerably higher consumer price growth. Indeed, the 2008 state budget law was developed based on an inflation forecast of 9.6% in 2008, while actual inflation exceeded 20% yoy in February and is unlikely to be reduced to single digits until the end of the year.

[1] This refers to the largest oil-extraction company "Ukrnafta". De jure, a 50% +1 share of the company belongs to the state; however, de facto the company is managed by a private partner. The law on the state budget for 2008 obliged the company to sell all extracted gas on the domestic market. Domestic gas prices are regulated by the government. Considering the government price is substantially underestimated, the company reduced its oil and gas extraction by 4.3% yoy and 4.6% yoy respectively over the first quarter of 2008.

[2] Reduction of crude oil deliveries is attributed to a decline of domestic oil-extraction as well as crude oil imports. High international crude oil prices amid outdated domestic oil-refining technologies, which do not allow for deep oil-refining, made imports of gasoline more attractive than its refining.

[3] Expenditures from the general fund of the state budget were under-fulfilled by more than 10% in the first two months of the year. At the same time, this year's budget execution improved compared to 21.4% below target expenditures in the respective period last year.

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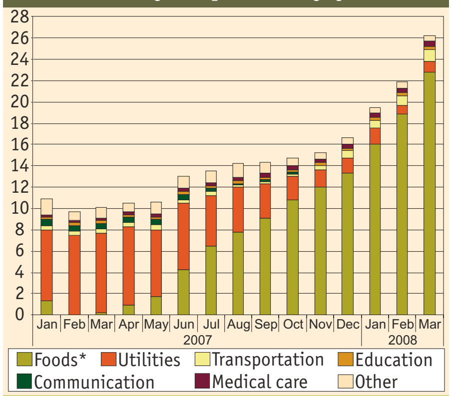
Loose fiscal policy over the last several years contributed to the build up of considerable inflationary pressures. Observing a notable acceleration of consumer price growth since the beginning of the year, the government has indicated that the 2008 fiscal deficit will be reduced to 1.5% of GDP, down from the previously targeted 2.1% of GDP. The government postponed the issuance of Eurobonds to contain inflationary pressures that may originate from the conversion of these bonds into national currency. Moreover, this year the government will increase reliance on domestic borrowing to finance its fiscal deficit. So far, the government has received UAH 370 million ($73.3 million) from issuing domestic bonds. However, domestic debt principal payments were almost twice as large over the same period, resulting in a 1.7% year-to-date (ytd) reduction in public and publicly guaranteed domestic debt. At the same time, thanks to receiving $300 million of the second development loan from the World Bank, as well as depreciation of the Hryvnia with respect to the Euro and other world currencies, Ukraine's external public and publicly guaranteed debt grew by 2.4% ytd.

Monetary Policy

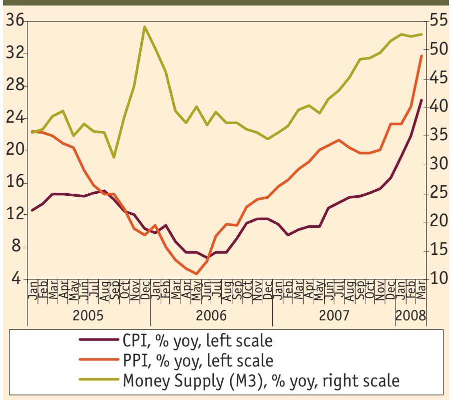
CPI by Component, % yoy



Source: State Statistics Committee, The Bleyzer Foundation

Following the surge in consumer inflation to 16.6% yoy in December 2007, the consumer price index continued to increase at a fast pace. Advancing by 2.9% month-over-month (mom) in January 2008, consumer inflation seemed to lose its pace in February when prices grew by 2.7% mom. However, the next month's inflation beat record levels, picking up by 3.8% mom, bringing the annual increase to 26.2%. Acceleration of inflation is primarily attributed to an increase in food prices, the largest component of the consumer price index. Food inflation sped up to 40.7% yoy in March, up further from 23.7% yoy in 2007, explaining more than 85% of consumer price growth over the period. Rallying world crude oil prices and reduction of domestic oil-refining led to a 50.5% yoy increase in domestic fuel and diesel prices and a 21.4% yoy rise in transportation services. Surging food prices as well as rising wages translated into higher prices in healthcare and education.

CPI, PPI and Money Supply Developments

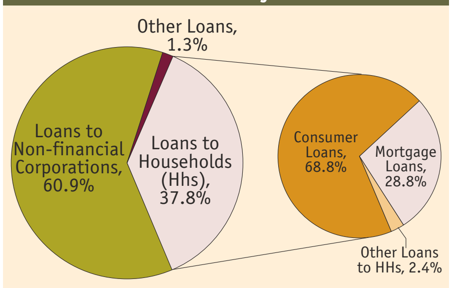


Source: State Statistics Committee

Though supply side factors such as a poor harvest in 2007, high energy prices[4], and the fast growth of global non-energy commodities and raw materials had a strong impact on domestic prices, the marked acceleration of price growth at the end of 2007/beginning of 2008 should be attributed to prolonged aggregate demand growth, considerably outpacing the rise in productivity. The boost to demand came from expansionary monetary and fiscal policies over the last several years.

Fiscal budget expenditures have grown rapidly since 2004 by about 20% per year in real terms. These expenditures were directed principally to increased pension payments, wage increases and social programs for low-income households, whose consumer basket is heavily biased towards food items. In addition, due to the fixing the Hryvnia exchange rate to the dollar amid large trade surpluses and capital inflows, the National Bank of Ukraine had to purchase large amounts of foreign exchange in order to maintain the peg, thus injecting liquidity into the economy. These purchases of foreign exchange by the NBU contributed to the rapid growth of money supply, which on average increased by about 45% per year over 2004-2007 and accelerated to 52.8% yoy in March 2008. While expansionary fiscal and monetary policies had a rather limited impact on inflation in previous years thanks to the fast growth of money demand that accompanied high rates of GDP growth, they contributed to the build up of inflationary pressures. Reinforced by several supply-side shocks, they began to be fully felt in the second half of 2007.

Domestic Credit by Borrower, end of January 2008



Source: NBU, The Bleyzer Foundation

Loose monetary conditions as well as large private sector borrowing from abroad led to rapid increases in commercial bank credit, which averaged 70% per year during the last three years. In January 2008, commercial banks' credit portfolios picked up by an extraordinary 78% yoy. High loan growth rates were reported to both corporations and households. Strong demand for loans from corporations was driven by buoyant investment activity and the need to finance working capital. At the same time, annual growth in loans to households grew at a faster pace. In 2007, bank credits to households grew by 98% yoy. Just in two years, their share grew from about 25% at the end of 2005 to 37.6% at the end of 2007. Moreover, almost 70% of all household loans were for consumer purposes. High growth of consumer loans contributed to strong consumption growth and thus added to inflationary pressures.

At the same time, the measures the NBU has been taking since the end of 2007 to contain rapid credit growth (as a main strategy to reduce aggregate demand and thus tame inflation) have already started to bear fruit. In particular, expansion of bank credit has been losing speed, advancing by 76.1% yoy in March, down from 78% yoy in January. Following the NBU's tightening of reserve requirements and capital adequacy norms in November 2007, a

[4] Despite a 37% increase in 2007 and another 38% rise in imported natural gas prices, it was allowed only partial pass-through to consumers during 2007/early 2008. However, they were spilling over into consumer inflation through skyrocketing producer prices. The latter soared by 31.7% yoy in March 2008.

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rise in its discount rate by 200 basis points to 10% since the beginning of 2008, and sizable sterilization operations (since November 2007, NBU has absorbed about $12 billion of excess liquidity) amid global liquidity tightening, credit interest rates started to increase. At the same time, with the strong financial support of a number of foreign banks that have entered the Ukrainian banking system in the last two years as well as high domestic inflation, the increase was reported primarily for the cost of hryvnia denominated loans (the weighted average credit rate grew to 15.2% pa in March 2008, up from 13.9% pa in January 2008, while that on forex-denominated loans was 10.8% pa in March 2008, up slightly compared to the previous months but lower than in January 2008 and December 2007 — 10.9% pa and 11.2% pa respectively).

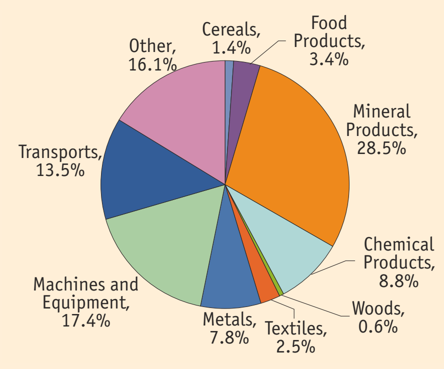
Trying to reduce its purchases of foreign exchange as the main source of flooding the market with hryvnia liquidity, the NBU has allowed for greater flexibility of the hryvnia exchange rate on the inter-bank market since mid-March. As a result, the Hryvnia/US dollar exchange rate went to the lower bounds of the exchange rate band set in the Main Foundations of Monetary Policy for 2008 — UAH/$ 4.95. Already for some time, a number of IFIs as well as domestic experts have called for relaxing the exchange rate regime, which would give the central bank greater maneuverability to combat inflation and will provide for the necessary cushion in case of adverse external shocks. However, the NBU resisted amid concerns that such a measure would weaken already deteriorating external balances. The recent relaxing of the exchange rate regime (despite the fact that officially the exchange rate remained unchanged) may signify that the priority to tame galloping inflation outweighs concerns over deteriorating trade and current account balances.

NBU measures along with government efforts and the expected good harvest this year will result in slower price growth in the second half of 2008. For 2008, inflation is expected to be in the range of 15–18%.

International Trade and Capital

Booming commodity prices (particularly on steel, chemical, food products) and robust investment demand in Ukraine's main trading partner countries supported robust export growth. In 2007, goods exports picked up by 28% yoy, underpinned by a 26.5% yoy increase in the export of metallurgical products, 20.2% yoy in chemical goods, and about a 45% yoy increase in agricultural and food commodities. Export of machinery and transport vehicles recorded impressive 53% yoy growth. However, continuing high growth in domestic demand, surging energy and raw material prices, and rising transportation costs caused even higher growth in imports. In particular, CIF merchandise imports grew by almost 35% yoy. On a positive note, capital goods amounted to about 17.5% of total merchandise imports. In addition, intermediate goods hold another significant share in imports, suggesting that the widening trade deficit was partly investment-driven.

Structure of Ukraine's Merchandise Imports, 2007

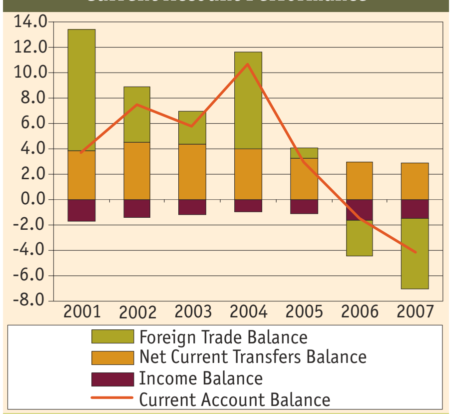


Source: State Statistics Committee, The Bleyzer Foundation

Driven by sharp deterioration of the merchandise trade deficit, Ukraine's current account deficit widened to $5.9 billion in 2007, representing 4.2% of GDP. Despite the widening CA gap, the strong capital inflow allowed for not only covering the gap but also replenishing international reserves. According to BoP data, the net FDI inflow amounted to a record high $9.2 billion, partially thanks to a number of acquisitions in the banking sector and food processing. Moreover, despite global financial turbulence, Ukraine received $5.75 billion of portfolio investments in 2007, while its external private debt grew by more than 70%. As a result, the financial account surplus (analytical representation of balance of payments) reached 11.2% of GDP, which allowed the NBU to raise its international reserves to $32.5 billion, a level sufficient to cover more than 4.5 months of future import of goods and services.

Buoyant growth of world steel and food prices promises another year of robust export growth for Ukraine in 2008. However, export performance was somewhat disappointing in January as it reported a rather moderate 14% yoy increase. The slowdown should be primarily attributed to slower growth in metals exports, the weightiest component of Ukraine's exports. Accounting for about 42% of total merchandise exports, metallurgical products exports grew by a meager 1.8% yoy in January, which was closely related to poor metallurgical industry performance at the beginning of the month. The next month, however, the growth of metallurgical exports recovered at a strong 28.1% yoy, bringing the two month increase to 14.8% yoy. In addition, export of machinery and transport equipment decelerated to about 28% yoy, which may be attributed to a very high base for comparison (in January 2007, export of these commodities soared by almost 62% yoy). Similarly to metallurgy, the growth recovered strongly in February to almost 65% yoy. On the back of rallying food prices, export of agricultural and food products expanded by more than 60% yoy over January-February. In addition, high world chemical prices helped the chemical industry to adjust to more expensive energy costs. Export of chemicals advanced by a decent 23.8% over the period.

Current Account Performance



Source: NBU, The Bleyzer Foundation

At the same time, imports are also expected to grow strongly this year. Further import growth will be supported by a 38% rise in imported natural gas prices since the beginning of the year, growing other energy and raw material prices, as well as continued strong domestic demand. At the same time, the growth of the latter may decelerate due to combined efforts of the NBU and the government to reduce aggregate demand, the likely more restricted access to financial resources abroad, etc.

So far, however, available data does not allow for an accurate account of foreign trade transactions over the first two months of the year. Official external trade statistics for January-February do not include the volumes and value of imported natural gas. Since the beginning of 2008, the price for imported natural gas grew by 38%. According to the gas agreements negotiated in 2006, Ukraine should have received gas of Central Asian origin at $179.5 per 1000 m3 at the Ukrainian border from mediator RosUkrEnergo, a joint venture of Russia's gas monopoly Gazprom and several private partners. At the border, all imported gas should have been resold to another mediator UkrGazEnergo, a joint venture of RosUkrEnergo and Naftogaz Ukraine. However, the new government initiated a revision of this gas delivery scheme aimed at reducing the number of mediators. In mid-February, Ukraine and Russia agreed that imported gas will be delivered to Naftogaz Ukraine (instead of UkrGazEnergo); however, the agreement was signed in March of this year. Due to the absence of a contract, the imported natural gas could not have been registered at Ukraine's customs and hence was not reflected in official statistics. At the same time, excluding the value of imported natural gas to Ukraine also in the respective period last year, merchandise imports grew by substantial 47% yoy over the first two months of 2008. Due to continued widening of the foreign trade balance, Ukraine's current account gap is expected to increase to about 6% of GDP. At the same time, it will be fully fundable thanks to ongoing strong, though somewhat weaker, inflow of FDI and other capital.

Other Reforms Affecting Investment Climate

On April 10th, the Ukrainian parliament ratified the country's accession to the World Trade Organization with an overwhelming 411 out of 450 votes in favor. Though several minor laws are still pending, Ukraine may join the Organization by June of this year. Ukraine has aspired for membership for the last 15 years. WTO membership will provide the country with a stable and predictable trade environment, giving strong growth impetus to multilateral trade and investments. Moreover, WTO accession is a prerequisite for a free-trade agreement with the European Union. Although WTO membership will be costly for selected sectors and industries (such as the automobile industry and agriculture), Ukraine will have a five-year grace period to adjust to new economic conditions.

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