Ukraine - Economic Situation

May 2008

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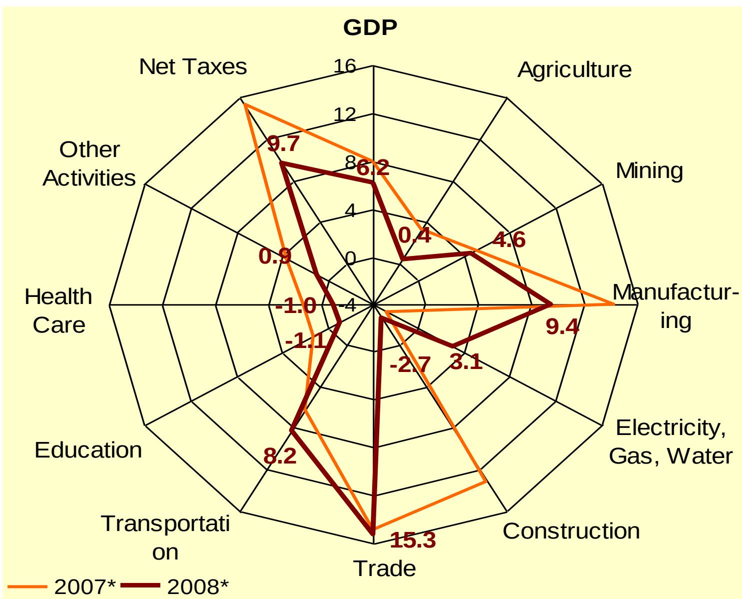
Summary

- Ukraine continued to enjoy robust economic growth as real GDP growth accelerated to 6.2% yoy over January-April. The growth was underpinned by continuing expansion in domestic trade, transportation, and industry.
- Despite favorable current performance and good prospects for agriculture in the second half of the year, economic growth is likely to moderate to about 5.5% yoy for the whole year.
- Realization of generous social promises taken during early 2007 parliamentary elections determined further substantial fiscal loosening in 2008. State budget expenditures grew by almost 55% yoy in nominal terms over January-March 2008. However, thanks to vigorous growth of tax revenues and under-execution of expenditures, consolidated budget was in surplus of 3% of period GDP.
- In April, consumer price inflation reached 30.2% yoy. While supply-side shocks contributed to current inflation developments, the major blame should be put on loose fiscal and monetary policies over the last few years.
- Anchoring nominal exchange rate stability amid large foreign capital inflows into the country were among the primary reasons of rapid growth of money supply. Since mid-April, the NBU allowed the inter-bank exchange rate to be determined by market forces reducing its forex operations. On May 22nd, it appreciated the national currency by 4% to UAH/$ 4.85. More flexible exchange rate regime will give the monetary authorities more room in their efforts to combat inflation.
- Favored by high world commodity prices, Ukraine's merchandise exports grew by strong 28.5% yoy in January-March. At the same time, imports surged at an impressive 45.1% yoy over the period, resulting in rapid deterioration of foreign trade and current account deficits.
- In mid-May, Ukraine became the 152nd member of the World Trade Organization.

Economic Growth

In 2008, Ukrainian economy continued to grow at a robust pace. Ukraine's GDP growth accelerated to 6.7% yoy in April, bringing the cumulative growth to 6.2% yoy. Economic growth was primarily led by an increase in value added in wholesale and retail trade, which grew by 15.3% yoy over the first four months of the year. Strong expansion in the sector is closely linked to buoyant consumption, supported by rising households' disposable income and continuing credit boom. Indeed, real disposable income of households grew by almost 20% yoy over the first quarter of 2008 (compared to 11.1% yoy in the respective period last year).

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



** Operative data*

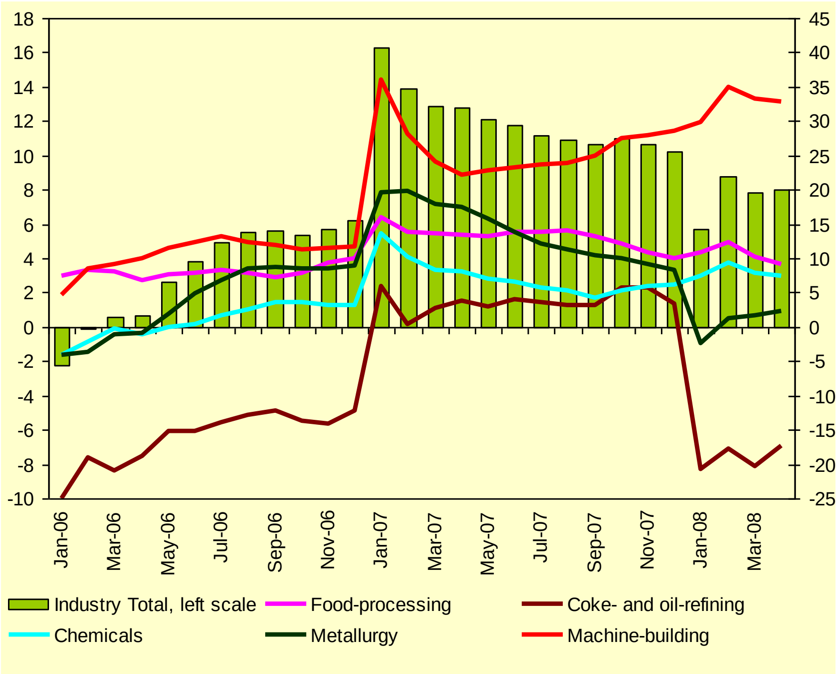
Source: State Statistics Committee of Ukraine

Growing population income, strong industry performance and external trade activity supported 8.2% yoy rise in value added in transportation over

January-April 2008. At the same time, the growth in the sector was slightly weaker compared to 8.7% yoy increase in the first three months of the year, which may be attributed to growing transportation costs, prolongation of grain export quotas and declines in crude oil transit and supply to Ukraine.[1] Favored by high international prices and strong domestic demand for iron ores, domestic extraction of ores and coal grew by 6.7% yoy and 2.4% yoy respectively, which outweighed a 3% yoy decline in extraction of crude oil and gas. As a result, Ukraine's mining industry reported a 4.6% yoy increase in value added over the first four months of the year.

Manufacturing was the second largest contributor to the GDP growth over January-April 2008 as value added in this sector advanced by 9.4% yoy, up from 9% yoy reported for the first three months of the year. Strong industrial sector performance was led by four major industries: food-processing, machine-building, chemicals and metallurgy. High domestic demand underpinned healthy 9.2% yoy output increase in food-processing. However, the industry growth kept decelerating as poor 2007 harvest continued to spill over this year. High world steel prices supported Ukraine's metallurgical production. However, higher energy and transportation costs as well as growing prices on raw materials (such as iron ores and coke[2]) resulted in moderate 2.3% yoy output expansion in January-April 2008. Production of chemicals grew by 7.5% yoy, underpinned by robust external demand. At the same time, chemical industry performance slightly worsened as output growth decelerated from 11.2% yoy in January-February, which may be attributed to adjustment to increased natural gas prices as well as weaker external demand on selected fertilizers (e.g., ammonia, international prices on which were declining since March this year). Machine-building production went up by about 33% yoy over January-April, underpinned by strong both domestic and external demand.

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



Source: State Statistics Committee

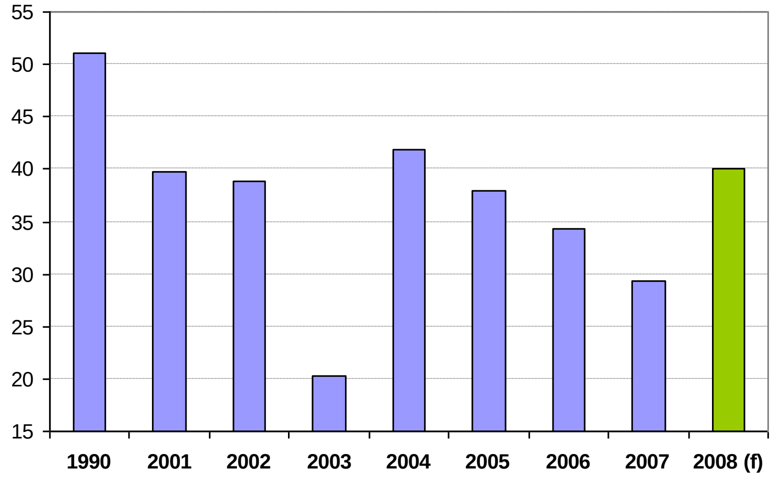
[1] According to the Ministry of Transportation and Communication, cargo railway transportation tariffs were raised by 12% since the beginning of February and 17% since the beginning of April. In November 2007, the government replaced the ban on grain exports with 1.2 billion quotas on grain exports during January 1-March 31 2008. Since the beginning of April, export quota on maize was abolished while the quotas on other cereals were extended till the end of April. On April 24, the quotas were prolonged till July 1st though enlarging their size to 1200 thousand tons for wheat (up from previous 200 thousand tons) and 900 thousand tons for barley (up from 400 thousand tons). However, uncertainty with grain export quotas during April resulted in a 2.9% reduction in grain rail transportation over January-April, compared to 28.8% yoy increase over the first two months of the year. The dispute between shareholders of closed joint-stock company "Ukrtatnafta", a company controlling one of the largest oil-refineries – Kremenchug, caused a decline in crude oil supply to Ukraine and transit. Thus, crude oil imports from Russia (accounting for almost ¾ of total crude oil supply in Ukraine during January-April 2007) declined by about a half over January-April 2008 compared to the respective period last year.

[2] High world iron ore prices stimulated exports of Ukraine's iron ores. While domestic extraction also increased (by 6.7% yoy in the first four months of the year), exports grew much faster. According to State Statistics Committee of Ukraine, the value of ores exports grew by about 50% yoy over the first three months of 2008. Moreover, about half of this growth was achieved thanks to higher export volumes. Domestic shortages amid strong external demand on coking coal (and thus more expensive imports) kept exacting a toll on Ukraine's metallurgical production through rising coke prices. Since the beginning of the year, coke producer prices grew by almost 10% and were about 65% yoy higher in April 2008.

On the downside, coke and oil-refining industry reported 17.3% yoy decline in output production, mainly due to lower volumes of processed oil. As the shortage of domestic coke was compensated for by imports, production of coke grew by 12.4% yoy over the period. In contrast, oil-refining production dropped by 28.5% yoy in January-April, affected by lower domestic oil extraction as well as crude oil imports. At the same time, oil-refining industry performance slightly improved compared to the first quarter of the year, which may be attributed to resumed fuel processing at one of the oil-refineries that were previously closed for repair and reconstruction works.

Construction continues to demonstrate weak performance as value added in the sector declined by 2.7% yoy over the first four months of the year. As more than 1/3 of all construction works are carried out in Kyiv, a deceleration in the volumes of construction works in the city, which may be related to early Kyiv council elections, to about 4.5% yoy in January-April, down from almost 11% yoy in 2007, notably contributed to poor construction sector performance. In addition, lower construction works may be attributed to rallying prices on construction materials, which might have depressed individual construction, as well as lower government financing of public infrastructure projects.

Grain Harvest in Ukraine, million tons



Source: State Statistics Committee, Ministry of Agriculture

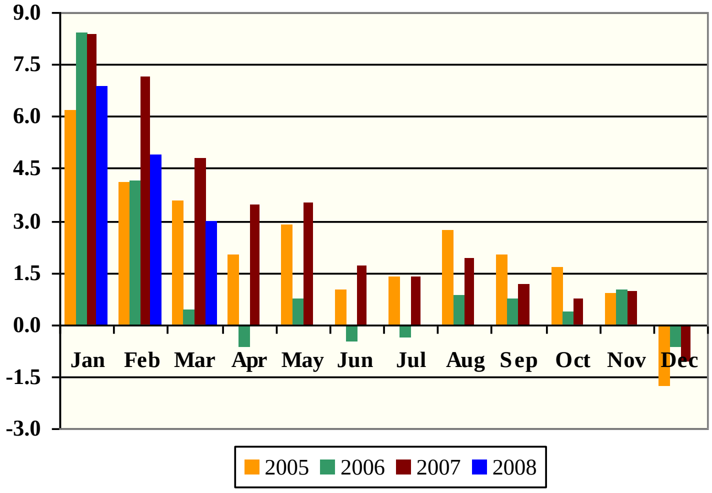
Value added growth in agriculture remained at 0.4% yoy in January-April. Favorable weather conditions formed rather optimistic forecast of grain harvest this year. The Ministry of Agriculture expects about 40 million tons of grain will be gathered this year, which will be a substantial increase compared to 29.3 million in 2007. As a result, agriculture is expected to recommence its position as one of the main contributors to economic growth.

Despite good prospects in agriculture, economic growth is likely to moderate to about 5.5% yoy for the whole year. The projection assumed that though domestic demand will remain to be the main driver of economic growth its paces of growth will weaken affected by high inflation and forecasted slower credit growth. The latter will be the result of tighter monetary policy and the spillover of financial turmoil on international markets through lower private sector external borrowings (particularly, commercial banks). Weaker credit growth will affect also investments. In addition, rapidly deteriorating foreign trade balance, as imports continue to notably outpace exports, will exact a toll on economic growth expansion.

Fiscal Policy

During the last three years, Ukrainian government authorities maintained prudent fiscal policy with consolidated budget deficits of less than 1.5% of GDP on average. However, budget expenditures that grew by about 30% yoy per year in real terms since 2004, gave strong impetus to population disposable income growth as the budget shifted toward distributing a larger fraction of budget revenues to consumption rather than investment spending. Thus, notwithstanding modest budget deficits, growing budget spending

Consolidated Budget Balance, % of period GDP



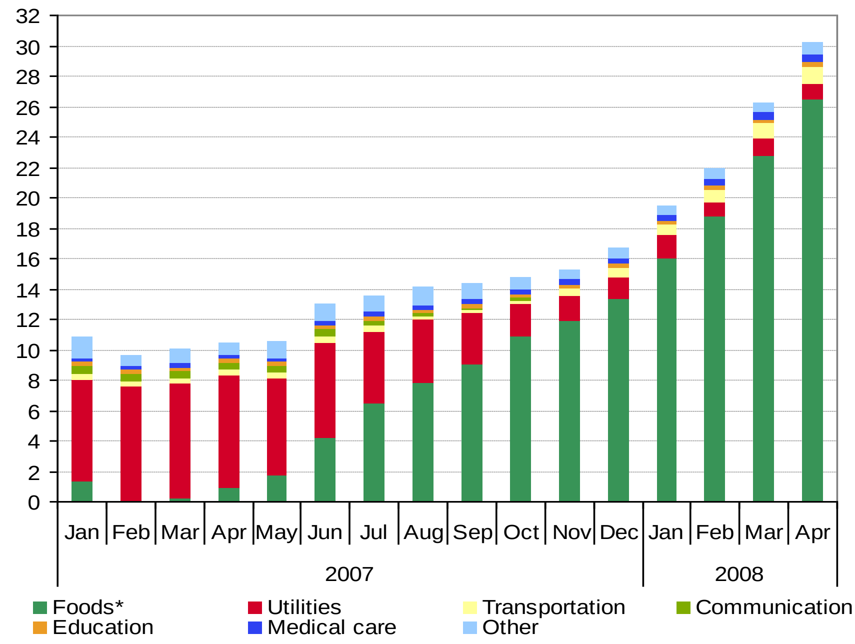
Source: Ministry of Finance

notably contributed to the built up of inflationary pressures.

Execution of generous social promises taken during early 2007 parliamentary elections determined further substantial fiscal loosening in 2008, though rallying inflation as well as widening current account deficit (the typical signs of economy overheating) called for fiscal tightening. Thus, state budget expenditures grew by almost 55% yoy in nominal terms over the first three months of the year with current transfers to population rising 2.2 times compared to the respective period last year, while capital expenditures were almost 20% yoy lower. In addition to raised minimum and living wages, which entailed multiplicative increase in public sector wages and pensions, an impressive increase in state budget consumer spending was attributed to compensation payments for depreciated Soviet-era savings. According to the Ministry of Finance, just in the first quarter of the year the government paid about UAH 4.4 billion ($870 million), which represents almost 10% of total state budget expenditures over the period and almost 73% of the planned amount for this purpose in 2008 state budget law.[3]

Despite large increases in budget expenditures, state budget expenditures were still below the target (general fund of the state budget was under-executed by 7.5%). Together with strong growth of budget revenues, state budget reported 0.6% of period GDP surplus at the end of March. Thanks to large positive local budget balances, consolidated budget surplus constituted almost 3% of GDP. As in the previous years, favorable fiscal performance was achieved thanks to robust growth of budget revenues. Over the fist quarter of 2008, consolidated budget revenues grew by nominal 40.2% yoy underpinned by 45.3% yoy increase in tax proceeds. Receipts from VAT, which account for about 45% of total tax revenues, grew by 45% yoy in nominal terms, reflecting booming consumption and buoyant foreign trade growth, as well as government efforts to streamline custom procedures. Fast growth of real households' disposable income inspired 44.5% yoy higher personal income tax collections over the period, while strong corporate profits generated 55.4% yoy increase in enterprise profit tax revenues. Due to rapid import growth, collections from import duties rose by 75.3% yoy.

CPI by component, % yoy



Source: State Statistics Committee, The Bleyzer Foundation

Despite current favorable performance, the fiscal outlook for the rest of the year remains uncertain. According to the 2008 State Budget Law, the deficit is targeted at UAH 18.8 billion or about 2.1% of forecasted GDP. As the state budget was developed on 9.6% end-of-period inflation forecast, state budget revenues as well as nominal GDP are likely to be higher, suggesting actual fiscal deficit may be notably lower. At the same time, state officials repeatedly called for amending the budget, in particular revising social expenditures to adjust for higher inflation. Moreover, about a half of fiscal deficit is planned to be financed through privatization receipts. Though the government approved an extensive list of enterprises to be privatized in 2008, including telecommunication monopoly "Ukrtelecom", chemical plant "Odessa pre-port plant", several energy supply companies *oblenergoes*, etc., privatization

[3] The 2008 State Budget Law envisages UAH 6 billion ($1.2 billion) for compensations for depreciated Soviet-era savings paid in cash and UAH 2 billion ($0.4 billion) to be paid as offset deal for utilities. Moreover, the government planned to allocate additional UAH 12 billion ($2.4 billion) from extra privatization revenues for these purposes. Considering that the government did not approved procedures of offsetting utility payments so far, sluggish privatization process and rallying inflation, we assume compensation payments will be limited to UAH 6 billion this year.

process was virtually stalled due to the absence of privatization program and dissent among key government officials regarding management of State Property Fund of Ukraine. Thus, privatization receipts amounted to just UAH 0.2 billion, or less than 2.5% of the targeted amount. In view of sluggish privatization proceeds, in April the government announced its plans to start issuance of Eurobonds yet in the first half of 2008. Previously, the government declared the issue will be postponed for the second half of the year to contain inflationary pressures that may originate from the conversion of these bonds into national currency. At the same time, the government did not provide additional information.

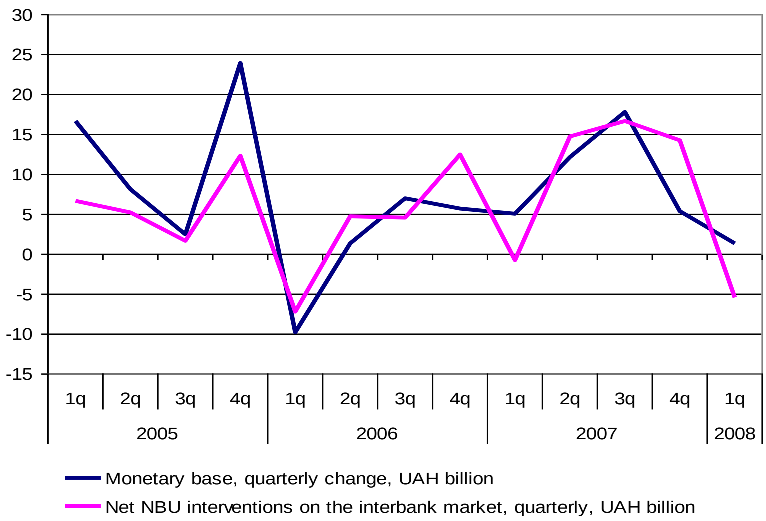
Monetary Policy

In April, consumer price index grew by 3.1% month-over-month. Though the price growth slightly slowed compared to 3.8% mom increase in March, April was the second month in a row with monthly inflation exceeding 3%. Moreover, in annual terms consumer prices continued to grow at a fast pace reaching 30% in April. As in the previous months, inflation was primarily driven by foods. In addition to fast price growth (47% yoy in April), foods are also the weightiest component in consumer basket, accounting for more than 50%.

To a significant extent, supply-side factors (such as poor 2007 harvest, growing global food prices, and higher energy prices) may be blamed for current inflation developments. However, a decrease in grain harvest was reported in many European countries, Australia and Northern America. Moreover, a decline in agriculture was much more severe in Bulgaria and Romania, where value added dropped by 30% yoy and 17% yoy in 2007 respectively. However, the price growth in these countries was much more moderate, while Ukraine demonstrated the highest inflation in the region and even in the world. This indicates that demand factors were the major contributors to building inflationary pressures over the last several years.

In addition to loose fiscal policy, the monetary policy framework of anchoring nominal exchange rate stability amid large foreign capital inflows into the country resulted in rapid growth of money supply. To defend the peg, the National Bank of Ukraine had to purchase large amounts of foreign exchange, thus injecting large sums of Hryvnias into the economy. The NBU sale of foreign currency in January and moderate purchases in February-March were reflected in monetary base deceleration to 41.5% yoy in March 2008, down from 46% yoy in 2007. However, in April net NBU purchases of foreign currency amounted to almost $620 million, which immediately translated into 6.3% mom increase in monetary base. As a result, annual monetary base growth accelerated to 45.6% in April. At the same time, due to slight growth deceleration of deposits (to 53.8% yoy in April vs. 54.3% yoy in March), money supply reported slightly slower growth of 52.2% yoy in April (down from 52.7% yoy a moth before).

Monetary Base and NBU Forex Interventions



Source: State Statistics Committee

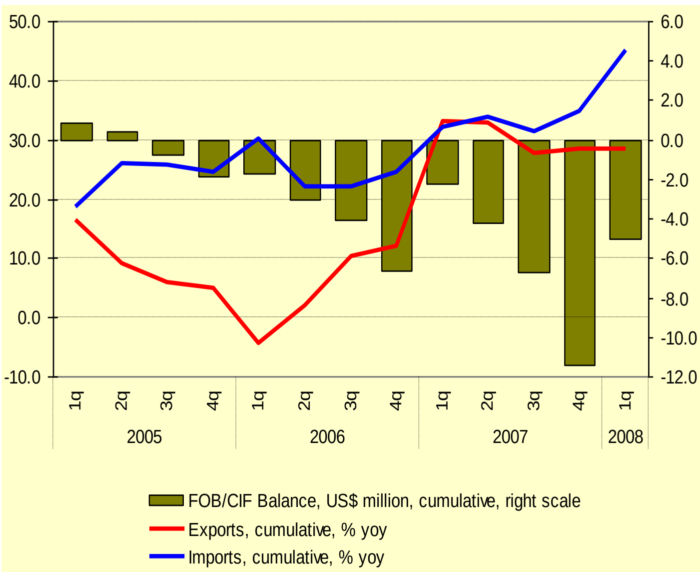
Since the end of 2007, the NBU has been taking efforts to contain rapid money supply and credit growth. Thus, tighter of reserve requirements, sizable sterilization operations as well as raising NBU discount rate has already started to translate into slower credit growth. Indeed, commercial banks loans to the economy of Ukraine grew by 74.8% yoy in April, down from more than 76% yoy in March. Moreover, at the end of April, the NBU raised its discount rate by 200 basis points to 12%. At the same time, rising interest rates amid keeping the exchange rate pegged will likely encourage higher inflows of foreign capital (especially on the back of widening international interest rate differentials due to the accommodative monetary policy of the major world central banks), which will be accumulated in the forex reserves of the NBU and, consequently, will increase money supply. Realizing this, since mid-April the NBU reduced its forex interventions on the inter-bank market allowing exchange rate to go beyond the lower bound of the exchange rate band set in the Main Guidelines of Monetary Policy for 2008 – UAH/$ 4.95. Moreover, on May 22nd, the NBU revalued the official hryvnia exchange rate with respect to US dollar by 4% to UAH/$4.85 to bring it in line with market-determined rate, which was appreciating since mid-April.

More flexible exchange rate regime is seen as an important step towards introduction of inflation targeting regime, which proved to be quite successful in reducing inflation in a number of countries. Moreover, greater exchange rate flexibility will provide for necessary cushion in case of adverse external shocks. On the other hand, lower NBU interventions at the forex market will cause hryvnia exchange rate to appreciate at least in the short run. Stronger hryvnia may hamper exports and encourage imports, contributing to even faster widening of current account deficit. Though the current level of current account deficit so far raised moderate concerns as it was fully covered by foreign direct investments. However, its sustainability crucially depends on government efforts to curb aggregate demand on the one hand and improve business and investment climate on the other. Better investment climate will not only help to attract long-term foreign investments, which will ease current account financing risks, but will also stimulate domestic supply.

International Trade and Capital

According to the State Statistics Committee of Ukraine, Ukraine's exports of goods grew by vigorous 28.5% yoy in the first quarter of 2008. Favored by high world steel and chemical prices, export of metallurgical and chemical products rose by 24.6% yoy and 23.4% yoy respectively. Robust growth in the CIS countries (particularly Russia), the main destination of Ukraine's machine-building export, inspired about 45% yoy increase in machinery and transport exports. Slight deceleration in export of this group from impressive 53% yoy increase in 2007 may be attributed to high statistical base effect as well as weaker growth in selected Asian CIS countries (e.g., Kazakhstan). High world food prices stimulated export of food products, edible oil, mill products, milk and dairy products (including eggs). Their export values grew by 36.6% yoy, 74% yoy, 2.1 and 2.5 times respectively. Following relaxation of grain export regime[4], export of cereals grew by 26% yoy in 1q 2008.

Merchandise Trade Performance



Source: State Statistics Committee

Despite favorable export performance, much faster growth in imports resulted in rapid deterioration of foreign trade deficit. According to the SSC, merchandise CIF imports grew by 45% yoy in the first quarter of 2008. As a result, FOB/CIF merchandise trade deficit widened to $5 billion, which was 2.3 times higher than in the respective period last year. High domestic demand for foods, edible oil and crop products inspires vigorous imports of these commodities. Respectively, import volumes were 35.3% yoy, 2.5 times, and almost 60% yoy higher in the first quarter of 2008. Imports of mineral products, the weightiest component in total merchandise imports, rose by 33% yoy over the period. Among this commodity group, imports of coal and gasoline grew the most dynamically – 117% yoy and 108% yoy respectively. As already mentioned, domestic shortages of coal, particularly coking coal, were the primary reason of strong import growth of coal this year. Falling domestic production of fuels as well as higher gasoline prices explained brisk imports of gasoline products. Surprisingly, value

[4] See footnote 1 for details.

of natural gas imports showed moderate 12.4% yoy increase over January-March 2008, while the price of it grew by 38% since the beginning of the year. Consequently, natural volumes of gas imports might have declined by about 20% yoy. Lower volumes of natural gas imports may be attributed to the revision of gas delivery schemes and payment delay for imported gas in the previous periods. During negotiations, daily natural gas supplies to Ukraine were cut by about 35% for several days. On a positive side, the share of investment goods imports kept growing as well. Thus, imports of machinery and electric equipment grew by about 27% yoy, while imports of transport equipment surged by almost 94% yoy. Imports of transport equipment were primarily driven by car imports, which is hard to differentiate between consumption and investment goods due to lack of information. At the same time, more than 4.5 times higher imports of railway transport equipment support the above argument.

Widening foreign trade deficit were the main course of deteriorating external balances of Ukraine. According to preliminary NBU estimates, current account gap widened to $3.5 billion in the first quarter of 2008, representing almost 9.5% of period GDP. The deficit, however, was virtually fully covered by surplus on financial account, with FDIs covering the most current account gap. However, the paces of CA deficit widening with growing reliance on external debt financing raise concerns over sustainability of its financing in the future. Reflecting rising internal (accelerating inflation) and external (widening current account gap) vulnerabilities, Fitch rating agency revised outlook of Ukraine's' sovereign rating from 'positive' to 'stable', though confirming its ratings.

Other Reforms Affecting Investment Climate

On May 16th, Ukraine became the 152nd member of the World Trade Organization (WTO). The negotiations for Ukraine's accession to the WTO had lasted for almost 15 years. During that period, Ukraine introduced a number of structural and economic reforms, underwent transition from planned to market economy, signed 52 bilateral agreements with WTO members, and adopted more than 50 legislation acts required for WTO membership. The most significant progress was achieved in the areas of intellectual property and minority shareholders rights protection, liberalization of foreign trade barriers, foreign banks and insurance sector regulations, improving banking legislation and preventing money laundering practices. WTO membership will provide the country with a sustainable and predictable trade environment and will give strong growth impetus to multilateral trade and investments. Moreover, it may facilitate Ukraine's European integration, as entry to the Organization was the main prerequisite for signing a free trade agreement with the EU.