SigmaBleyzer

# Ukraine
# Macroeconomic Situation

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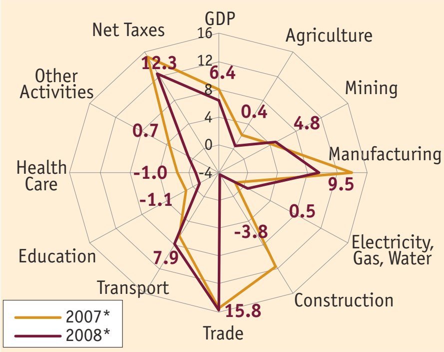
## Summary


- Ukraine continued to enjoy robust economic growth as real GDP growth accelerated to 6.4% yoy over January–May. The growth was underpinned by continuing expansion in domestic trade, transportation and industry.
- Realization of generous social promises made during early 2007 parliamentary elections caused further substantial fiscal loosening in 2008. State budget expenditures grew by almost 54% yoy in nominal terms over January–April 2008. However, thanks to vigorous growth of tax revenues and under-execution of expenditures, the consolidated budget was in surplus of 2% of period GDP.
- In May, consumer price inflation reached 31% 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.
- Continuing its efforts to combat inflation and credit growth, the NBU has raised its discount rate by 200 basis points to 12% at the end of April.
- Anchoring nominal exchange rate stability amid large foreign capital inflows were among the primary reasons for rapid growth of the money supply. Since mid-April, the NBU has allowed the inter-bank exchange rate to fluctuate beyond the officially set exchange rate band. On May 22nd, it appreciated the national currency by 4% to UAH/$4.85.
- Favored by high world commodity prices, Ukraine's merchandise exports grew by a strong 31% yoy in January–April. At the same time, imports surged by an impressive 50.3% 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, the Ukrainian economy continued to grow at a robust pace. Ukraine's GDP growth accelerated to 6.7% yoy in April and further to 7.2% yoy in May, bringing cumulative growth to 6.4% yoy. Economic growth was primarily led by an increase in value added in wholesale and retail trade, which grew by 15.8% yoy over the first five months of the year. Strong expansion in the sector is closely linked to buoyant consumption, supported by households' rising disposable income and the continuing credit boom. Indeed, real disposable income of households grew by almost 18% yoy over January-April 2008 (compared to 10.5% yoy in the respective period last year).

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

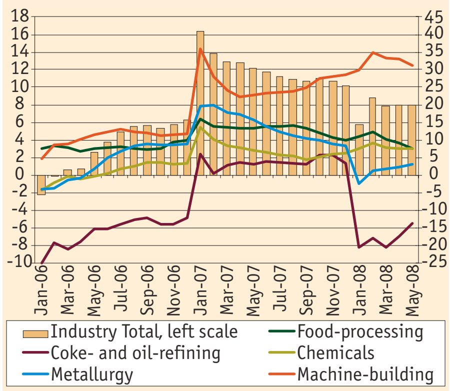



* Operative data
Source: State Statistics Committee of Ukraine

Growing population income, strong industry performance and external trade activity supported an 8% yoy rise in value added in transportation over January-May 2008. At the same time, the growth in the sector was slightly weaker compared to the 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 ore, domestic extraction of ore and coal grew by 6.4% yoy and 2.5% yoy respectively, which outweighed a decline in extraction of crude oil and gas. As a result, Ukraine's mining industry reported a 4.8% yoy increase in value added over the first five months of the year.

Manufacturing was the second largest contributor to GDP growth over January-May 2008 as value added in this sector advanced by 9.5% yoy, up from 9% yoy reported for the first three months of the year. Strong industrial performance was led by four major industries: machine-building, food processing, chemicals and metallurgy. High domestic demand underpinned a healthy 7.5% yoy output increase in food processing. However, industry growth kept decelerating as a poor 2007 harvest continued to spill over into 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 ore and coke[2]) resulted in a moderate 3.1% yoy output expansion in January-May 2008. Production of chemicals grew by 7.4% 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 select fertilizers (e.g., ammonia, on which international prices have been declining during March-May of this year). Machine-building production went up by about 31% yoy over January-May, underpinned by strong both domestic and external demand.

**Industrial Output by Selected Branches in 2006–2008, % yoy cumulative**




Source: State Statistics Committee

On the downside, the coke and oil-refining industry reported a 13.5% yoy decline in output production, mainly due to lower volumes of processed oil. As the shortage of domestic coke was compensated for by imports, domestic production of coke continued to increase. In contrast, oil-refining production dropped by 23.5%

[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 a quota during January 1-March 31 2008. Since the beginning of April, the export quota on maize was abolished while the quotas on other cereals were extended until the end of April. On April 24, the quotas were prolonged until July 1st by enlarging their size to 1,200 thousand tons for wheat (up from the 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. Though in May export of grain resumed, causing a 6.7% yoy increase in grain railway transportation over January-May, its growth still was a significant deceleration compared to a 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 3/4 of the total crude oil supply in Ukraine during January-May 2007) declined by almost a half over January-May 2008 compared to the respective period last year.

[2] High world iron ore prices stimulated exports of Ukraine's iron ore. While domestic extraction also increased, exports grew much faster. According to State Statistics Committee of Ukraine, the value of ore exports grew by about 50% yoy over the first three months of 2008. Moreover, about 40% of this growth was achieved thanks to higher export volumes. Domestic shortages amid strong external demand for 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 9% and were about 64% yoy higher in May 2008.





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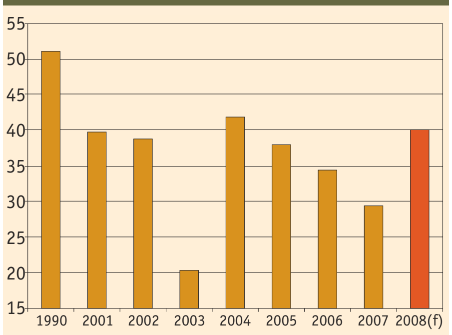
yoy in January-May, affected by lower domestic oil extraction as well as crude oil imports. At the same time, oil-refining industry performance slightly improved compared to the first four months of the year (a decline of 28.5% yoy). The improvement may be attributed to resumed fuel processing at an oil refinery that had been closed for repair and reconstruction.

Construction continues to demonstrate weak performance as value added in the sector declined by 3.8% yoy over the first five months of the year. As about 1/3 of all construction works are carried out in Kyiv, a deceleration in the volume of construction works in the city to about 3.6% yoy in January-May (down from almost 19% yoy in the respective period of 2007). The deceleration may be related to early Kyiv council elections. In addition, declining construction works may be attributed to rallying prices on construction materials, which may 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

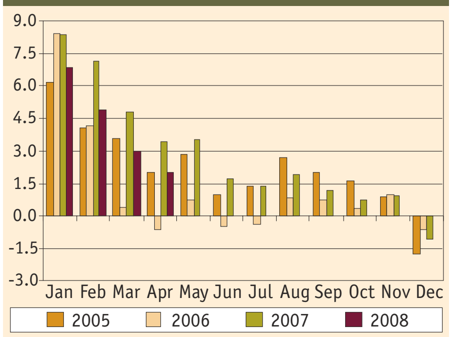
Value added growth in agriculture remained at 0.4% yoy in January-May. Favorable weather conditions formed a rather optimistic forecast of the grain harvest this year. The Ministry of Agriculture expects about 40 million tons of grain will be gathered this year, which will be a substantial increase compared to 29.3 million in 2007. Hence, 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 the main driver of economic growth, its rate of growth will weaken due to 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 also affect investments. In addition, the 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 authorities maintained prudent fiscal policy with consolidated budget deficits of less than 1.5% of GDP on average. However, budget expenditures grew by about 30% yoy per year in real terms since 2004, giving strong impetus to 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 notably contributed to the build up of inflationary pressures.

**Consolidated Budget Balance, % of period GDP**




Source: Ministry of Finance

Execution of generous social promises made during early 2007 parliamentary elections caused further substantial fiscal loosening in 2008, though rallying inflation as well as the widening current account deficit (the typical signs of an economy overheating) called for fiscal tightening. Thus, state budget expenditures grew by almost 54% yoy in nominal terms over the first four months of the year with current transfers to the population rising 85% compared to the respective period last year, while capital expenditures were 24% yoy lower. In addition to increased minimum and living wages, which entailed a 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, in the first four months of the year alone the government paid about UAH 4.8 billion (about $1 billion), which represents almost 8% of total state budget expenditures over January-April and almost 80% of the planned amount for this purpose in the 2008 state budget law.[3]

Despite large increases, state budget expenditures were still below target (the general fund of the state budget was under-executed by 6.5%). Together with strong growth of budget revenues, the state budget reported a 0.4% of period GDP surplus at the end of April. Thanks to large positive local budget balances, the consolidated budget surplus constituted 2% of GDP. As in previous years, favorable fiscal performance was achieved thanks to robust growth of budget revenues. Over the first four months of 2008, consolidated budget revenues grew by a nominal 43.5% yoy underpinned by a almost 50% yoy increase in tax proceeds. Receipts from VAT, which account for about 45% of total tax revenues, grew by 59% yoy in nominal terms, reflecting booming consumption and buoyant foreign trade growth, as well as government efforts to streamline customs procedures. Fast growth of real household disposable income led to 43% yoy higher personal income tax collections over the period, while strong corporate profits generated a 49% yoy increase in enterprise profit tax revenues. Due to rapid import growth, collections from import duties rose by 74% yoy.

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 a 9.6% end-of-period inflation forecast, state budget revenues as well as nominal GDP are likely to be higher, suggesting that the 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 half of the fiscal deficit is planned to be financed through privatization receipts. Though the government approved an extensive list of enter-

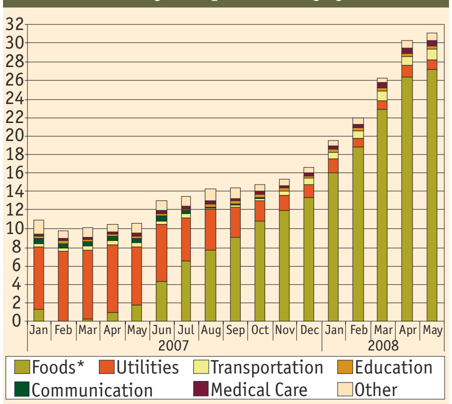
[3] The 2008 State Budget Law envisages UAH 6 billion ($1.2 billion) for compensation for depreciated Soviet-era savings paid in cash and UAH 2 billion ($0.4 billion) to be paid as an offset deal for utilities. Moreover, the government planned to allocate an additional UAH 12 billion ($2.4 billion) from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

prises to be privatized in 2008, including telecommunication monopoly "Ukrtelecom", chemical plant "Odessa pre-port plant", several energy supply *oblenergoes*, etc., the privatization process was virtually stalled due to the absence of a privatization program and dissent among key government officials regarding management of the State Property Fund of Ukraine. Thus, privatization receipts amounted to just UAH 0.2 billion, or 2.7% of the targeted amount. In view of the sluggish privatization proceeds, in April the government announced its plans to begin issuance of Eurobonds in the first half of 2008. Previously, the government declared that the issue would be postponed until the second half of the year to contain inflationary pressures that might 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, the consumer price index grew by 3.1% month-over-month (mom). Though the price growth slightly slowed compared to the 3.8% mom increase in March, April was the second month in a row with monthly inflation exceeding 3%. But in May consumer price growth notably decelerated reporting a 1.3% mom increase. May's monthly inflation was the lowest for the last nine months. However, in annual terms consumer prices continued to grow at a fast pace reaching 31% in May. As in the previous months, inflation was primarily driven by foods. In addition to paces of price increase (48.5% yoy in May), foods are also the weightiest component in consumer basket, accounting for more than 50%.

**CPI by Component, % yoy**

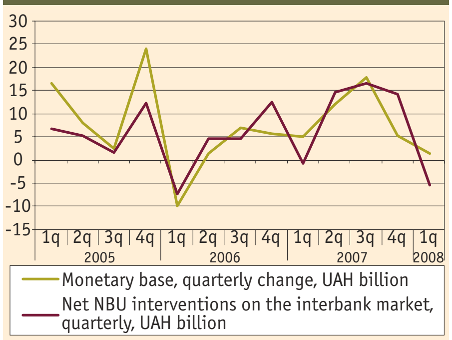



* Including beverages and tabacoo
Source: State Statistics Committee, The Bleyzer Foundation

To a significant extent, supply-side factors (such as the poor 2007 harvest, growing global food prices and higher energy prices) may be blamed for current inflation developments. However, a decrease in the grain harvest was reported in many European countries, Australia and North 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 a 6.3% mom increase in the monetary base. As a result, annual monetary base growth accelerated to 45.6% in April. Reinforced by strong growth in deposits, the money supply kept growing at a fast pace of 52.2% yoy in April.

**Monetary Base and NBU Forex Interventions**




Source: State Statistics Committee

Since the end of 2007, the NBU has been making efforts to contain rapid money supply and credit growth. It tightened reserve requirements, performed sizable sterilization operations and raised the NBU discount rate by 200 basis points to 10% since the beginning of 2008. Moreover, at the end of April, the NBU raised its discount rate by another 200 basis points to 12%. However, rising interest rates while 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). Defending the peg, they will be accumulated in the forex reserves of the NBU and, consequently, will increase money supply. Realizing this, the NBU allowed the exchange rate to go beyond the lower bound of the rate band set in the Main Guidelines of Monetary Policy for 2008 — UAH/$4.95. By mid-May, exchange rate appreciated to UAH/$4.8 on the inter-bank market, while the official rate was kept unchanged. However, on May 22nd, the NBU revalued the official hryvnia exchange rate with respect to the US dollar by 4% to UAH/$4.85 to bring it in line with the market-determined rate.

Foreign capital inflow remained quite significant. As a result, the NBU still had to intervene in the market to defend the hryvnia from a sharp appreciation. The NBU forex interventions amounted to $950 million in May. The impact of sizable NBU foreign currency interventions on monetary base growth was compensated for by accumulation of funds of government accounts with the NBU. Unlike in April when the government cash balances declined by UAH 3.2 billion ($635 million, UAH/$5.05), in May they grew by UAH 5.7 billion ($1.18 billion, UAH/$4.85). As a result, monetary base grew by a moderate 0.6% mom in May. In annual terms, monetary base growth decelerated to 39%. Valuation adjustments as well as rising inflation and exchange rate uncertainty explain a 0.8% mom decline in the stock of deposits in May. Slower monetary base and deposits growth translated into modest reduction of money supply. Indeed, money supply (M3) declined by 0.1% mom that month. In annual terms, money supply growth decelerated to 49%.

Tighter monetary policy caused liquidity constraints in the Ukrainian banking system. The interbank credit rate, which serves as the closest indicator of banks' liquidity stance, reached 27% per annum in mid-May. Liquidity shortages have translated into slower credit growth. Commercial bank loans to the economy grew by almost 69.5% yoy in May, down from about 75% yoy in April and 78% yoy in January 2008.

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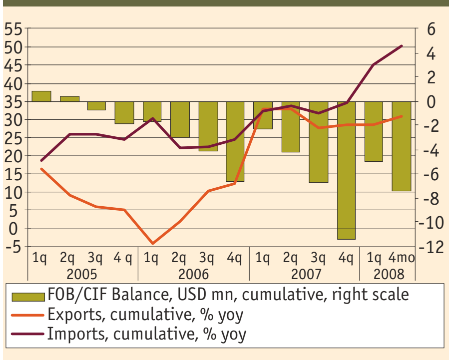
A more flexible exchange rate regime is an important step towards introduction of an inflation targeting regime, which proved to be quite successful in reducing inflation in a number of countries. Moreover, greater exchange rate flexibility will provide for a necessary cushion in case of adverse external shocks. On the other hand, fewer NBU interventions on the forex market will cause the hryvnia exchange rate to appreciate at least in the short run. A stronger hryvnia may hamper exports and encourage imports, contributing to even faster widening of the current account deficit. The current account deficit has so far raised only 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 the business and investment climate on the other. A 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

**Merchandise Trade Performance**




Source: State Statistics Committee

According to the State Statistics Committee, Ukraine's exports of goods grew by a vigorous 31% yoy in the first four months of 2008. Favored by high world steel and chemical prices, export of metallurgical and chemical products rose by 33.5% yoy and 19% yoy respectively. Robust growth in CIS countries (particularly Russia), the main destination of Ukraine's machine-building exports, drove a 44.4% yoy increase in machinery and transport exports. A slight deceleration in exports of this group from the impressive 53% yoy increase in 2007 may be attributed to a high statistical base effect as well as weaker growth in select 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 32.2% yoy, 38.5% yoy, 2.6 and 2.2 times respectively. Following prolongation of the grain export quotas[4], export of cereals declined by 6.5% yoy in January-April 2008.

Despite favorable export performance, much faster growth in imports resulted in rapid deterioration of the foreign trade deficit. According to the SSC, merchandise CIF imports grew by 50.3% yoy in the first four months of 2008. As a result, the FOB/CIF merchandise trade deficit widened to $7.4 billion, which was 2.5 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 values were 37.1% yoy, 2.4 times, and almost 93.5% yoy higher in January-April 2008. Imports of mineral products, the weightiest component in total merchandise imports, rose by 42.2% yoy over the period. Within this commodity group, imports of coal and gasoline grew the most — 122% yoy and 120.5% yoy respectively. As already mentioned, domestic shortages of coal, particularly coking coal, were the primary reason for 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, the value of natural gas imports showed a moderate 14.6% yoy increase over January-April 2008, while its price grew by 38% since the beginning of the year. Consequently, volumes of natural gas imports may have declined by about 17% yoy. Lower volumes of natural gas imports may be attributed to the revision of gas delivery schemes and payment delay for imported gas in previous periods. During negotiations, daily natural gas supplies to Ukraine were cut by about 35% for several days. On the positive side, the share of investment goods imports kept growing as well. Thus, imports of machinery and electric equipment grew by about 32% yoy, while imports of transport equipment surged by almost 90% yoy. Imports of transport equipment were primarily driven by car imports, but it is hard to differentiate between consumption and investment goods due to lack of information. At the same time, more than 5 times higher imports of railway transport equipment support the above argument.

The widening foreign trade deficit was the main cause of Ukraine's deteriorating external balances. According to preliminary NBU estimates, the 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 almost fully covered by the surplus on the financial account, with FDI covering most of the current account gap. However, the pace of CA deficit widening with growing reliance on external debt financing raises concerns over the sustainability of its financing in the future. Reflecting rising internal (accelerating inflation) and external (widening current account gap) vulnerabilities, Fitch revised the 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 shareholder 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 for 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.

[4] See footnote 1 for details.

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