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Summary

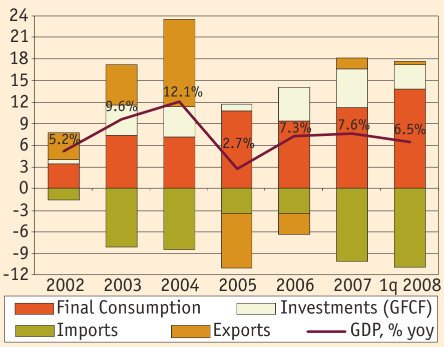
- The Ukrainian economy remained on a path of strong growth. Though June's statistics revealed GDP growth deceleration, it is seen as a natural response to policy tightening since the beginning of the year. The latter were needed to ease macroeconomic disequilibrium, which has manifested strongly since the second half of 2007 through accelerating inflation and a deteriorating current account balance.
- Given the time lags in achieving increases in supply, the government relied on measures to cool aggregate demand.
- The government has been taking a number of fiscal measures to reduce inflationary pressure. Most importantly, despite above-target revenues, the government has maintained fiscal discipline. Over the first five months of the year, the consolidated budget was in surplus of 3.4% of period GDP. However, fiscal policy is believed to not be tight enough. Moreover, the second half of the year is likely to see further increases in government social spending.
- With the limited scope of fiscal tightening, the current anti-inflationary program relies heavily on monetary measures, which have already led to deceleration of money supply and credit growth.
- Inflation reversed to a descending trend, reporting a 29.3% yoy increase in June, down from 31.1% yoy.
- The current account deficit continued to widen despite Ukraine's strong export growth.

Economic Growth

According to operative statistics, GDP expanded by a real 6.3% yoy in the first half of 2008, supported by continued high growth in domestic trade, industry, transport and communication. Robust growth of 14.8% yoy, 7% yoy and 8.4% yoy in these sectors respectively compensated for the negative contributions of construction, healthcare and education sectors as well as stagnation in agriculture.

At the same time, June's real sector statistics may signal that the growth trend turned to deceleration. Since January 2008, growth rates have exceeded 6% and there has been a clear trend of acceleration. In June, however, real GDP growth slowed to 5.4% yoy compared to 7.2% yoy in May. At the same time, such deceleration is seen as a natural response to macroeconomic policy tightening since the beginning of the year. The latter was aimed at easing macroeconomic disequilibrium, which has manifested strongly since the second half of 2007 through accelerating inflation and a deteriorating current account balance.

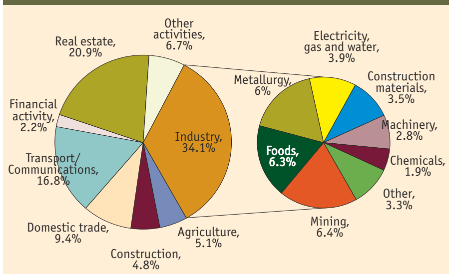
Contributions to Real GDP Growth by Expenditure, percentage points



GFCF — gross fixed capital formation
Source: State Statistics Committee, The Bleyzer Foundation

Since 2004, private consumption became the principal driver of economic growth, rising by 18% on average each year. Moreover, it accelerated to 22% yoy in 1Q 2008, up from 19% yoy in 1Q 2007, reflecting loose fiscal and income policies and high credit growth. In particular, real disposable income grew by 16% yoy over the first five months of 2008, up from 10.8% yoy in the respective period last year, while wages rose by 9.5% yoy in real terms in the first half of 2008.

Investments into fixed capital, 2007, % of total



Source: State Statistics Committee

Moreover, economic growth was also supported by buoyant investment activity. Investment into fixed capital grew by 21.5% per year on average during 2006–2007. However, the lion's share of these investments was allocated to real estate, domestic trade, and production of semi-final or exporting goods, while investment in agriculture, food processing, machinery, and other manufactured products accounted for only about 20%.

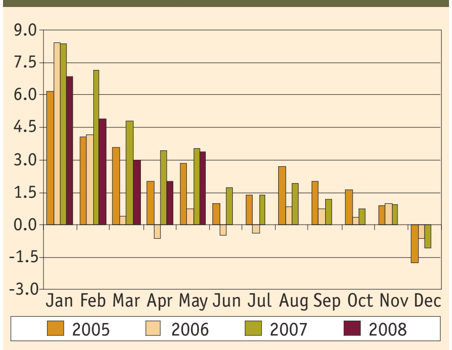
In addition, economic growth since 2000 has been based on utilization of existing facilities to a significant extent. However, according to the Business Activity Survey carried out by the NBU on a quarterly basis, this opportunity has virtually ceased. The studies showed that more than 2/3 of surveyed enterprises have been working at full or exceeding their capacities.

Given the above, Ukraine's capacity to meet robust consumer demand growth observed during the last couple of years was largely constrained. Coupled with several adverse supply-side shocks (much higher energy prices, the poor 2007 harvest), supply rigidities led to excess demand being absorbed through higher prices and imports. In particular, imports grew by 19.7% yoy in real terms in 2007 and accelerated to 20.2% yoy in the first quarter of 2007.

As supply side initiatives are slow in reducing inflation in the short-term, the only available option to curb inflation was restricting aggregate demand, though such actions may be painful for economic growth. To ease inflation-growth trade-off and facilitate expansion of domestic supply, the government must support its monetary and fiscal tightening with a comprehensive package of structural reforms that will improve Ukraine's business and investment climate. So far, the economy is expected to continue its gradual cooling with real GDP growth reaching 5.5–6% for the whole year.

Fiscal Policy

Consolidated Budget Balance, % of period GDP



Source: Ministry of Finance

With inflation being the main macroeconomic concern, the government and the NBU has been taking measures to restore macroeconomic stability. Anti-inflation policy includes a mix of fiscal and monetary tightening to restrict aggregate demand. At the same time, though acknowledged to be the most efficient way of slowing demand growth, fiscal tightening is still a challenge for the government due

Where Opportunities Emerge.

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to short election cycles, unbalanced executive power, and a generally turbulent political environment. At the same time, the government has been taking a number of fiscal measures to reduce inflationary pressures. First, the government postponed the issuance of Eurobonds, of which the conversion into Hryvnias may have added to inflationary pressures and which relies on domestic borrowing to smooth financing of government spending during the year. It is also true, however, that the external environment for placing new Eurobonds is less favorable this year[1]. Global financial turmoil, entailing overall risk reassessment, as well as lingering political instability and signals of macroeconomic disequilibrium in Ukraine resulted in a notable increase in spreads on Ukrainian securities.

Second, the government put its emphasis on improving tax administration and streamlining custom procedures. In particular, thanks to modernization of customs and introduction of automotive systems in administering VAT, custom revenues and VAT proceeds surged by 98% yoy and 64.3% yoy respectively in nominal terms over the first five months of the year. Moreover, electronic administration of VAT allowed for substantial reduction of VAT arrears. Thanks to rising population income and the healthy financial stance of Ukrainian enterprises, receipts from personal income and corporate profit taxes grew by 42% yoy and 58% yoy respectively. As a result, consolidated budget revenues grew by a nominal 46.5% yoy.

Third, despite above-target budget revenues, the government has kept expenditures below plan, accumulating extra revenues on its Treasury account. As a result, the consolidated budget was in surplus of 3.4% of period GDP. At the same time, it is worth noting the fairly uneven distribution of budget expenditures. While current expenditures (public wages, social transfers, etc.) grew by a nominal 50% yoy in January-May, investment projects remained significantly underfinanced. Indeed, capital expenditures grew by only 12% yoy in nominal terms over the period and represented less than 6% of total consolidated budget expenditures for the period. Fourth, the government announced the resumption of the gas price pass-through to final consumers, which has remained unchanged since January 2007. This may help to improve the financial stance of the public utility sector and to reduce the burden for the budget.

Though these measures are helpful, they are believed to not be strong enough to cool aggregate demand and anchor inflation expectations. Moreover, the fiscal outlook in the second half of the year still remains uncertain. There is increasing political pressure to amend the budget law, raising social benefits to compensate for higher prices as low income groups tend to suffer the most from higher food and energy prices. Thus, at the beginning of July, the government developed draft amendments to the 2008 Budget Law, raising revenues and expenditures but leaving the deficit virtually unchanged. According to the proposed amendments, public pensions and other social benefits would have increased further, reflecting the intended rise in the subsistence wage by 13.1% starting July 1st, instead of the previous 2.1%.[2] Yet these amendments were not supported by the parliament. However, the government still found a way to raise social expenditures. In mid-July, the Cabinet of Ministers issued Resolution #654, designating pension supplements to various categories of retirees and disabled and envisaging an increase in other social benefits. This initiative will cost about UAH 0.5 billion ($103 million) per month and is planned to be financed through above-target revenues to the State Pension Fund of Ukraine.

Following the severe floods that have hit Western Ukraine, at the end of July the budget was amended to compensate for their disruptive effects on human settlements, economic activities, and infrastructure. In particular, budget expenditures were raised by UAH 5.8 billion ($1.2 billion), or by 2.5%, to UAH 240 billion ($49.5 billion)[3]. Budget revenues were increased by 2.7% to UAH 221 billion ($45.6 billion), adjusting for higher inflation and raised excises on tobacco. The targeted budget deficit was kept at UAH 18.8 billion ($3.9 billion). With nominal GDP higher than forecasted in the budget and strong revenue growth, the deficit may stand below 1.5% of GDP in 2008. However, September is likely to see another budget revision, as financing of the main budgetary programs was left unchanged.

Monetary Policy

With the limited scope of fiscal tightening, the current anti-inflationary program relies heavily on monetary measures. Following the revaluation of the official exchange rate to UAH/$4.85 in mid-May, the NBU amended the Main Guidelines of the Monetary Policy for 2008, setting the indicative exchange rate band at UAH/$4.85 plus/minus 4%. Formally, the NBU switched to a managed floating exchange rate regime, as it allowed the official exchange rate to fluctuate, though quite moderately (+0.1%/-0.2% around UAH/$4.85 during June-July). By allowing the Hryvnia to appreciate, the NBU attempted to reduce inflationary pressures stemming from large purchases of foreign currency on the interbank market and increasing de-dollarization of the economy. Moreover, a more flexible exchange rate regime will make monetary policy more efficient, providing for a necessary cushion in case of adverse external shocks and better control over money and credit growth.

Official UAH/$ exchange rate, April-July 2008

Source: NBU

Liberalization of the exchange rate regime accompanied other NBU measures to tighten monetary conditions and address growing banking sector vulnerability to various risks. In late 2007/beginning of 2008, the NBU tightened reserve and capital requirements, performed sizable sterilization operations, raised its discount rate by 400 basis points to 12%, strengthened bank supervision (in particular, it made more stringent disclosure of banks' financial information requirements, increased inspections, etc.). As a result of these measures, excess liquidity of commercial banks notably declined. In particular, cash balances on banks correspondent accounts, which together with the interbank credit rate may serve as an indica-

[1] According to the State Budget Law for 2008, about 2/3 of the projected budget deficit in 2008 is planned to be financed through privatization receipts. However, as of May UAH 283 million (about $57.5 million) was received from privatization, or 3.2% of the targeted amount for 2008.

[2] According to Ukrainian legislation, a number of social benefits are tied to the subsistence wage.

[3] Including net lending from the budget.

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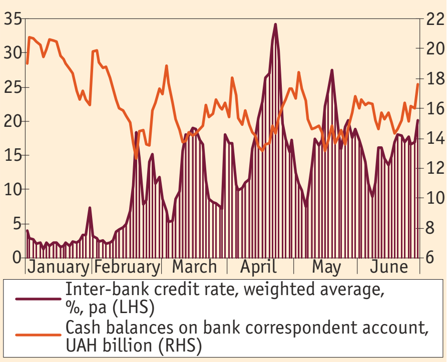
tor of banking sector liquidity, fell from about UAH 20 billion at the beginning of the year to less than UAH 16 billion at the end of May 2008. Though fluctuations of interbank credit rates narrowed considerably during June compared to the previous two months, they remained at a rather high level of about 15.5% pa on average.

Banking Sector Liquidity Stance in 1H 2008

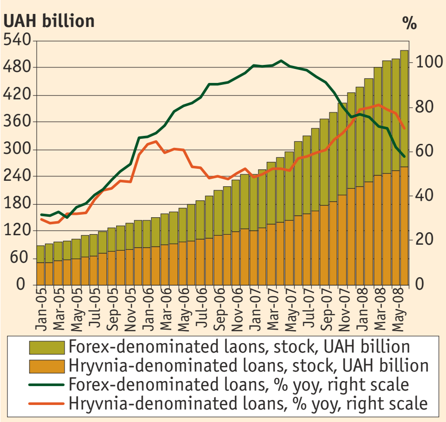


Source: NBU

Liquidity constraints have translated into slower credit growth, though the growth of deposits remained strong. In particular, deposits grew by almost 50% yoy in June 2008. Slight deceleration from about 54% yoy growth during March-April may be attributed to valuation adjustments coming from official exchange rate appreciation in May (about 1/3 of total commercial bank deposits are denominated in foreign currency). The growth of commercial bank loans to the economy declined to 64.1% yoy in June, down from about 78% yoy at the beginning of the year. Moreover, credit growth is expected to continue to decline as the NBU has been taking more measures to curb external borrowing of commercial banks, and thus credit growth.

Aggressive commercial bank borrowing from abroad was among the primary reasons of explosive credit growth in Ukraine during the last couple of years. Moreover, it contributed to high dollarization of the economy as the share of forex-denominated credit grew from about 40% in 2004 to more than 50% in mid-2007. According to the NBU, gross external debt of the banking system grew by 125% per year on average during 2006–2007. What's more, a significant part of commercial bank debt is short-term. Though it declined from about 50% in 2005 to less than 40% in 1Q 2008, it exceeded $12 billion at the end of 1Q 2008 in nominal terms. Furthermore, according to external debt methodology, classification of the external debt by short- and long-term is made at the moment of contracting the debt. This means that if the short term maturities of the long term foreign liabilities of commercial banks are included, the amount would be much higher. Growing indebtedness of the banking sector raises its vulnerability to adverse external shocks, increasing the difficulty in rolling over short term debt in case of a sudden deterioration in investor sentiment. Observing the situation, the NBU decided to tighten reserve requirements on short-term funds attracted from abroad in mid-June. Thus, starting August 1st, commercial banks are required to reserve 20% of attracted foreign funds with less than 6-month maturity instead of the previous 4%. Moreover, the NBU imposed strict penalties for violating this requirement.

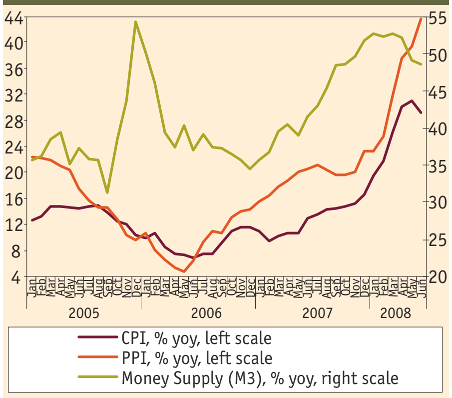
Commercial Banks Credit Activity



Source: NBU

Despite a revaluation of the Hryvnia, a rise in interest rates attracted large foreign capital inflow to the country. Coupled with strong export activity and still buoyant private sector borrowing from abroad, this led to significant over-supply of foreign currency on Ukraine's inter-bank forex market. To defend the Hryvnia from further sharp appreciation and observing liquidity shortages in the banking system, the NBU intervened in the market to buy out the surplus of foreign exchange. In June alone, net forex purchases exceeded $1 billion. The impact of NBU interventions on the monetary base was reinforced by a UAH 3.7 billion decline in cash balances on government accounts. As a result, the monetary base expanded by 5.7% month-over-month (mom), compared to a moderate 0.6% mom increase in May. Thanks to faster growth in deposits, which advanced by 4.7% mom in June compared to a 0.8% mom decline in the previous month, money supply growth was more moderate — 4.7% mom in June. In annual terms, monetary base growth remained virtually unchanged, while money supply growth continued to decelerate.

CPI, PPI and Money Supply Developments



Source: State Statistics Committee, NBU, The Bleyzer Foundation

Tighter monetary policy, controlled fiscal expenditures and the start of the new harvest supply helped to reverse the inflation trend. In June, consumer prices grew by 0.8% mom, a rate favorably compared to the 2.2% mom increase in June 2007 and the 2.8% average monthly growth rates during the first five months of the year. In annual terms, consumer price growth declined to 29.3% in June, down from 31.1% in May. The deceleration in inflation was observed for the first time since February 2007. The declining trend is expected to continue until the end of the year thanks to the expected good harvest, high statistical base effect and the ongoing anti-inflationary program. However, given fiscal tightening constraints (moreover, the realization of the announced/planned social expenditure increases), high producer price inflation, proclaimed rise in utility tariffs, and high gasoline prices, inflation may not fall below 20% this year.

International Trade and Capital

Ukraine's export performance has been improving since the beginning of 2008. In May, exports of goods grew by 53.6% yoy, bringing cumulative growth to 35.8% yoy. High world steel, chemical, agricultural and food prices, as well as strong investment demand in CIS countries (the main destination of Ukraine's machinery and transport equipment exports) underpinned vigorous export growth of the respective goods. In particular, exports of metallurgical products grew by almost 40% yoy over January-May despite

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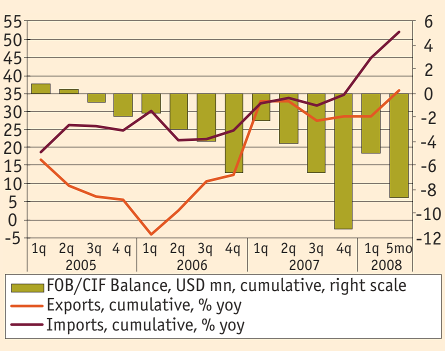
moderate output growth in metallurgy over the period. Exports of machinery and transport equipment rose by about 45% yoy, chemicals by 27% yoy, agricultural and food products by about 29% yoy over the period. However, imports continued to outpace exports, surging by 59% yoy in May. The cumulative growth of merchandise imports exceeded 52% yoy. Due to its large share in total imports (about 1/3) and rallying energy prices, imports of mineral products, advancing by 47.8% yoy, were the main contributor to January-May's growth of total imports. In particular, imports of gasoline and coal surged by 197% yoy and 108.5% yoy respectively. High world steel, chemical, agricultural and food prices induced 47.5% yoy, 44.5% yoy, 74% yoy and 36% yoy growth in imports of the respective products. Imports of machinery and transport equipment accelerated to 57.3% yoy.

Merchandise Trade Performance



Source: State Statistics Committee

At the same time, due to the high mismatch in the rates of export and import growth, the merchandise trade deficit continued to deteriorate, reaching $8.8 billion in January-May 2008. The widening trade deficit was the primary cause of the worsening current account balance. According to the NBU, the CA deficit was twice as large in Jan-May 2008 as in the respective period of 2007, reaching $6.2 billion or 9% of period GDP. Though FDI inflows, estimated at about $4 billion in January-May, were almost 40% higher than in the respective period of 2007, they did not fully covered the CA gap as in previous years. At the same time, together with active private sector borrowing from abroad, they allowed not only to cover the deficit, but also to replenish gross international reserves of the NBU, which reached $35.4 billion at the end of June, sufficient to cover 4.1 months of future imports of goods and services.

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