

Monthly Economic Monitor Ukraine

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2008

- The work of the Parliament remained blocked in February.
- Real GDP growth decelerated to 4.9% yoy in January due to the contraction of construction.
- A new scheme of gas deliveries was negotiated between the Presidents of Russia and Ukraine.
- In February the tender for the 99.52% shares of Odessa by-port plant was launched.
- In mid-February export grain quotas were finally distributed and grain shipments started.
- Central fiscal surplus reached 0.9% of GDP in January as the execution of expenditures was low at the beginning of the year.
- Real household income increase by 16.7% yoy in 2007 supported by increase in wages, social transfers and capital incomes.
- Inflation rate accelerated to 21.9% yoy in February.
- The NBU strengthened capital adequacy requirements.

Politics: The Parliament remains inactive in February

In February the Party of Regions continued blocking the work of the Verkhovna Rada. The official reason has been a disagreement with the coalition on the accession to the NATO, namely the signing of the common Letter by the President, Prime Minister and Speaker of the Parliament to the NATO Secretary-General expressing Ukraine's aspiration to join the Membership Action Plan. Speaker Arseniy Yatsenyuk initiated reconciliation negotiations among factions, but a compromise was achieved only at the beginning of March.

Prolonged failure of the Parliament to start the regular session work could triggered its dissolution by the President, although the legal situation was dubious. On one hand, according to the Constitution, the President has the right to dissolve the Parliament if the regular session doesn't start during the thirty days after official starting date envisaged in the Constitution, namely the first Tuesday of February. On the other hand, the Parliament cannot be dissolved within a year after pre-term elections caused by the decision of the President to dissolve the Parliament. It remained ambiguous whether the Verkhovna Rada could be dissolved in this situation, as early elections held in September 2006 were officially grounded on the decision of 150 deputies to quit the Parliament, although initiated by the Presidential decrees dissolving the Verkhovna Rada. The long-lasting period of political uncertainty, although having a minor effect on short-term economic trends in the country, hurts its medium-term perspectives, hampering the legislative changes needed to continue the reforms in Ukraine.

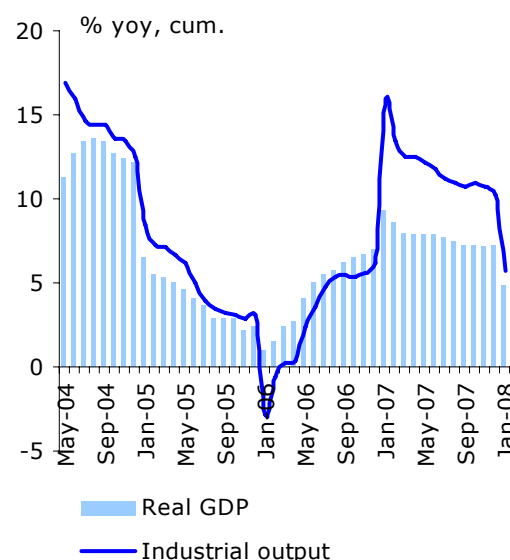
Real economy: Real GDP grew at 4.9% yoy in January

In line with expectations, the economic growth slightly decelerated in January 2008 against high statistical base of the previous year. According to the Derzhkomstat, real GDP increased by 4.9% yoy in the first month of the year in comparison to 9.3% yoy growth a year ago. Value added increased in all major sectors except construction, where the rate of contraction was 8.6% yoy likely due to lower volumes of housing construction. Though, it is expected that the construction sector growth will revive during the year fuelled by the demand for offices and infrastructure. The IER forecasts that the real GDP growth will reach 6.2% yoy in 2008.

Industrial output increased by 5.7% yoy in January against 16.3% yoy rise a year ago. The tendency of the previous year was mostly preserved, with machine building contributing the most to the growth. Though, the metal production contracted by 2.4% yoy, likely due to a slack season on the world market and increased input prices. The rising metal prices and Ukraine's WTO accession are expected to improve the sector's performance over the year.

Population: 46.4 m
Industry/GDP: 32%
Agriculture/GDP: 8%
Investment/GDP: 27%
Exports to: Russia 26%, EU 28%
Imports from: Russia 28%, EU 37%

Real growth rates of GDP and industrial production



Source: Derzhkomstat

Institute for Economic Research
and Policy Consulting
Reytarska 8/5-A, 01034 Kyiv
Tel. (+38044) 278-6342
Fax (+38044) 278-6336
E-mail: institute@ier.kiev.ua
<http://www.ier.kiev.ua>

Sectoral trends: A new scheme of gas deliveries was negotiated

Energy. In early February Russian Gazprom threatened to cut gas supply to Ukraine if it does not pay debts accumulated at the end of 2007 and at the beginning of 2008. The company also claimed that Ukraine should pay for gas consumed in 2008 USD 314 per thousand cubic meters (tcm) rather than USD 179.5 per tcm agreed in December 2007, as the shortage of Central Asia gas resulted in more expensive Russian gas deliveries. On February 12, Presidents of Ukraine and Russia have agreed that Ukraine will repay the debt at price of USD 179.5 per tcm. Besides a new scheme of gas deliveries was negotiated: the current intermediaries RosUkrEnergo and UkrGazEnergo were to be replaced by new companies created by Gazprom and Naftogaz on a parity basis. Though, no documents formalising those gas deals were signed. At the end of the month the gas conflict escalated and Gazprom decreased gas supply to Ukraine by almost a half for several days. Non-transparency of gas price formation, supply, and payment schemes were in the core of the conflict, and only the establishment of clear mechanisms of market functioning could ensure the stable gas supply in the future.

Privatisation. The Cabinet of Ministers approved the list of objects for privatization in 2008 containing 387 enterprises, including Ukrtelecom (67.8% of shares), Odessa by-port plant (99.52%), Turboatom (75.22%), and shares in oblenergoes. Fourteen objects are to be sold together with land lots, the practice expected to increase the value of the proposed objects. Also, in February the tender for the 99.52% shares of Odessa by-port plant was launched. The auction should start in 75 days. The tender description foresees the starting price at UAH 3 bn and some investment conditions.

Agriculture. In February export grain quota at 1.2 m tons was finally distributed and the grain shipments started. As Ukraine grain export potential exceeds current quota, the Cabinet of Ministers developed the draft law envisaging increase in grain export quotas to 2.9 m tons and its prolongation from March to June 2008. Ukraine obliged to eliminate currently applied quantitative restrictions after it becomes the WTO member.

Transport. Railways freight transportation tariffs were increased by 12% in February. Further tariff increases are foreseen in April (17%), July (3%), and October (3%). Also, discrimination among tariffs on transportation in different directions will be eliminated in line with the WTO accession commitments. Rail administration explains the rise in tariffs by non-profitability of railroads and necessity to invest in equipment. To ensure railroads efficiency, tariffs increase is to be accompanied by sector reforms to improve the quality of services.

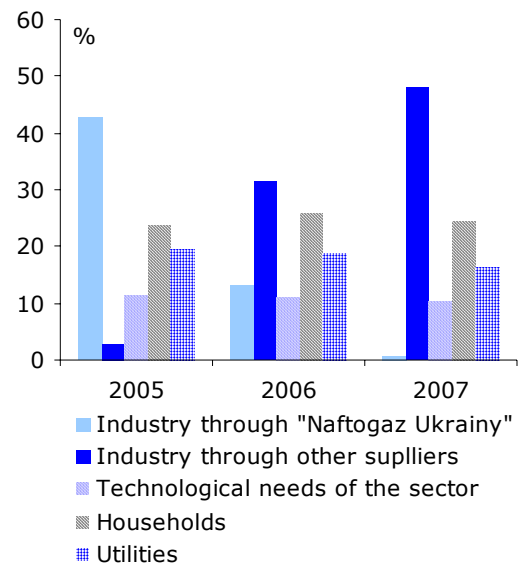
External sector: Trade deficit widened in 2007

According to the Derzhkomstat, trade deficit in goods and services reached USD 7.3 bn in 2007, as compared to USD 2.9 bn a year ago. Commodity trade deficit amounted USD 11.4 bn, while service trade was in surplus of USD 4.1 bn. Both in goods and services export growth rates lagged behind the growth of imports, revealing strong rise in domestic demand in the country. In particular, in 2007 commodity exports increased by 28.4% yoy in dollar terms, while imports were 34.7% yoy up. In services, exports grew by 19.8% yoy, and imports by 31.2% yoy. Higher growth rates of service imports are maintained since 2003, but a significant difference in values of exports and imports of services has so far allowed retaining the positive balance. Ukraine trades mostly with neighbours. In 2007 the CIS countries accounted for 39% of total turnover in goods and services, and the respective share for the EU was 34%.

Fiscal policy: Central fiscal surplus was 0.9% of GDP in January due to under-execution of expenditures

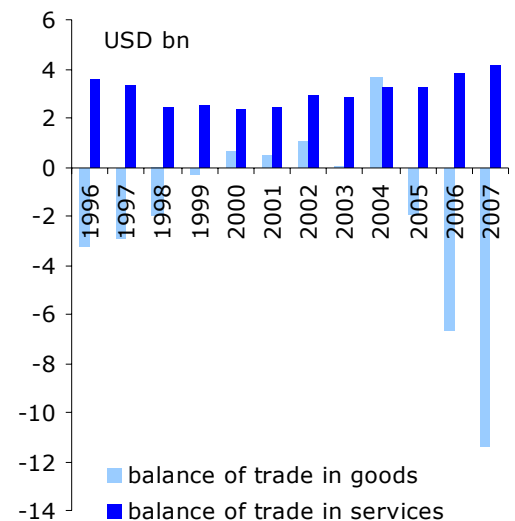
In January central fiscal revenues were 7.2% above the target due to high tax revenues likely attributed to higher than forecasted inflation. In particular, the enterprise profit tax was over-executed by 24%,

Natural gas consumption in Ukraine between 2005 and 2007



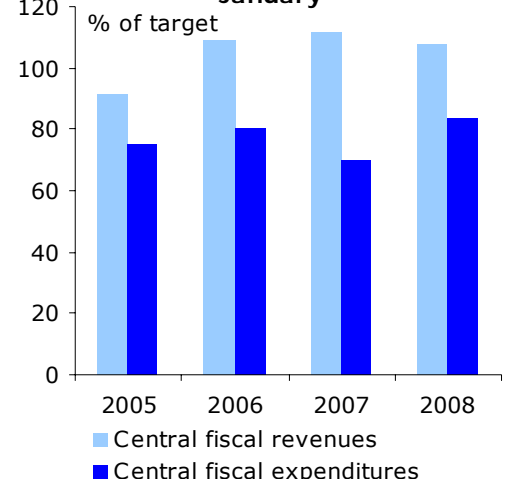
Source: Energobusiness

Balance of trade in goods and services



Source: Derzhkomstat

Central budget execution in January



Source: State Treasury reports

and VAT revenues from domestic and imported goods were 5% and 3% above the plan, respectively. At the same time, the central fiscal expenditures were 16% below the target due to traditional management problems at the beginning of the year. Social payments were executed at the highest rate of 98.5%, while central fiscal expenditures on utilities were 60.7% below the target. As a result, the central fiscal surplus was UAH 0.5 bn or 0.9% of GDP.

Social policy: Real household incomes grew by 16.7% in 2007, fuelling consumption boom

In 2007 Ukraine retained high consumption growth, supported by growth of household incomes and consumer loans. Real household income grew by 16.7% yoy as compared to 19.1% yoy in 2006, backed by growth of all income components. Wages incomes, though growing at a slower pace than in 2006 (15.5% yoy and 26.9% yoy, respectively), remained the primary source of household earnings, accounting for 42.7% of total income. The social payments and current transfers increased by 13.1% yoy, which is 2 percentage points higher than a year ago. The growth rates of incomes received from agricultural and entrepreneurship activities decelerated in the second half of the year most likely due to the poor harvest. Due to a rapid growth in property incomes (55.9% yoy), their share in total income increased to 3.4%.

Monetary policy: Short-term interest rates went up in February

Monetary base increased by 44.9% yoy and money supply by 52.4% yoy in February. Restrictive monetary policy and new capital adequacy requirements caused a sharp decrease of free liquidity. Short-term money market rates shot up to 10-20% p.a. forcing some banks to request costly refinancing from the NBU at 14.5-15% p.a. While free liquidity increased by the end of the month, overnight interest rates remained in double digits. If high interest rates hold on, they can put downward pressure on inflation and real economic activity.

In February consumer prices grew 21.9% yoy. Food prices growth was limited as supply and demand move closer to balance, and social spending remained stable. But statistical base effect and high inflation expectations exerted upward pressure on the CPI causing overall acceleration of inflation.

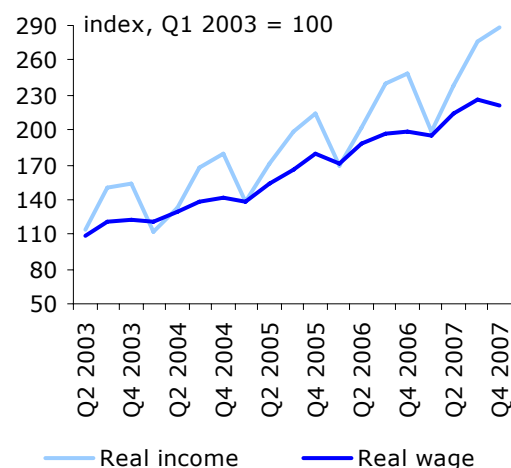
Financial markets: New strengthened bank capital adequacy requirements came into force

Banking. In mid-February new capital adequacy requirements came into force. According to NBU regulation, banks have to calculate risk-weighted capital adequacy ratio taking into account open currency position and term gaps. Such strengthening could partially explain the low level of liquidity observed in mid-month. Those measures should improve bank liquidity management and encourage banks to use more the national currency to manage their credit-profiles more efficiently.

Exchange rate. Most of February the UAH/USD inter-bank exchange rate fluctuated over upper half of 5.00-5.06 UAH per USD exchange rate band. However, the NBU intervened on the market only several times as supply and demand were mostly balanced. On February 20 and 21 exchange rate was close to UAH 5.00 per USD as banks sold off dollars facing a shortage of liquidity.

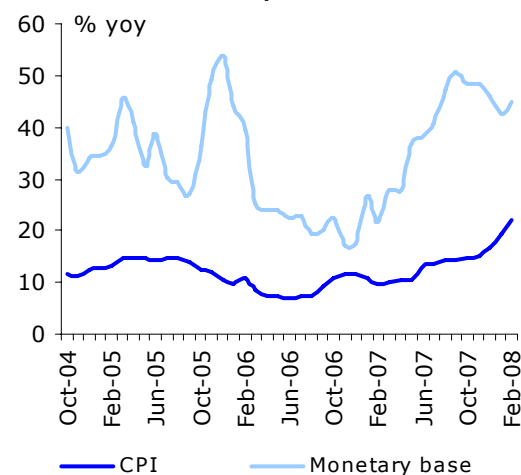
State debt. In February the Ministry of Finance continued additional placement of the five-year domestic state bonds maturing in 2010-2011. They were placed on the total amount of UAH 77.7 m with average yield of 7.5% p.a., that is 40 basis points higher than in January. It means that the government will face a pressure to increase the yield to sell future issues of domestic bonds.

Households' real income and wage



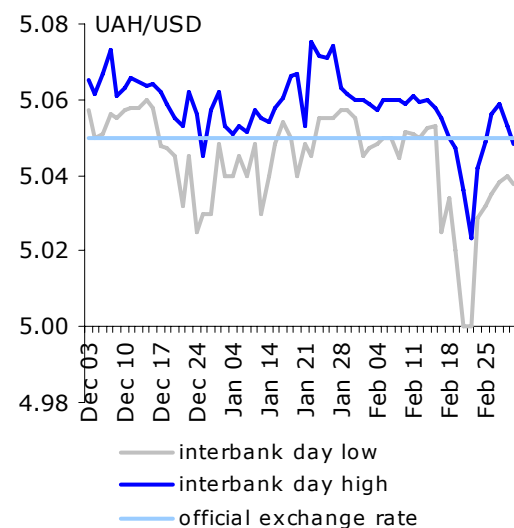
Source: Derzhkomstat

CPI and monetary base development



Source: Derzhkomstat, NBU

Exchange rate



Source: Reuters Investor



Economic Trends		Q3 06	Q4 06	Q1 07	Q2 07	Q3 07	Q4 07	Oct	Nov	Dec	Jan	Feb
GDP growth (real)	% yoy	6.9	9.5	8.0	7.9	6.4	...	7.0	6.9	7.3	4.9	...
GDP growth (real)	% yoy cum.	6.1	7.1	8.0	7.9	7.3	7.3	7.3	7.2	7.3	4.9	...
Industrial production (real)	% yoy cum.	5.5	6.2	12.5	11.8	10.7	10.2	11.0	10.7	10.2	5.7	...
Agricultural production (real)	% yoy cum.	-2.8	0.4	5.0	6.3	-5.1	-5.6	-5.7	-5.7	-5.6	0.0	...
CPI	% yoy eop	9.1	11.6	10.1	13.0	14.4	16.6	14.8	15.2	16.6	19.4	21.4
PPI	% yoy eop	10.7	14.4	17.9	20.6	19.6	23.3	19.7	20.0	23.3	23.3	25.6
Exports (USD)***	% yoy cum.	10.7	13.2	32.4	32.4	27.3	...	27.4"	27.9"	28.4"
Imports (USD)***	% yoy cum.	19.8	22.0	32.0	33.2	31.5	...	32.9"	34.2"	34.7"
Merchandise trade balance	USD bn cum.	-2.93	-5.19	-1.75	-3.18	-5.38	...	-8.22"	-9.59"	11.42"
Current account	USD bn cum.	-0.32	-1.62	-1.31	-2.00	-2.15	...	x	x	x	x	x
Current account	% GDP, cum.	-0.4	-1.5	-5.0	-3.4	-2.2	...	x	x	x	x	x
Gross international reserves	USD bn eop	19.1	22.3	22.9	25.9	30.6	32.5	31.7	32.8	32.5	31.8	32.5
Monetary Base	% yoy eop	20.3	17.5	27.7	38.4	50.6	46.0	48.5	48.4	46.0	42.7	44.9
Lending rate on UAH credits **	% pa, aop	14.6	15.1	14.0	13.9	13.7	14.0	13.7	14.0	14.4	13.9	14.6
Exchange rate (official)	USD aop	5.05	5.05	5.05	5.05	5.05	5.05	5.05	5.05	5.05	5.05	5.05
Exchange rate (official)	EUR aop	6.43	6.51	6.62	6.81	6.93	7.31	7.18	7.40	7.36	7.42	7.63

SOURCES: Derzhkomstat, Ministry of Finance, NBU, IFS, own calculations

" Monthly figures are only for merchandise exports and imports (source: Derzhkomstat)

Quarterly figures are for trade in goods and services (source: NBU)

* Monthly figures do not include the regular quarterly revision of the GDP series

**Weighted average for different maturities (source: NBU)

*** Growth rate in dollar terms

Key Economic Indicators		1999	2000	2001	2002	2003	2004	2005	2006	2007
Nominal GDP	UAH bn	130.4	170.1	204.2	225.8	267.3	345.1	441.5	537.7	709.4
Nominal GDP	USD bn	31.6	31.3	38.0	42.4	50.1	65.0	86.2	106.5	140.5
GDP growth (real)	% yoy	-0.2	5.9	9.2	5.2	9.6	12.1	2.7	7.1	7.3
Industrial production	% yoy	4.0	13.2	14.2	7.0	15.8	12.5	3.1	6.2	10.2
Agricultural production	% yoy	-6.9	9.8	10.2	1.2	-11.0	19.7	-0.1	0.4	-5.6
CPI	% yoy aop	22.7	28.2	12.0	0.8	5.2	9.0	13.5	9.1	16.6
CPI	% yoy eop	19.2	25.8	6.1	-0.6	8.2	12.3	10.3	11.6	12.8
PPI	% yoy aop	31.5	20.9	8.6	3.1	7.6	20.5	16.7	9.6	19.5
PPI	% yoy eop	15.7	20.8	0.9	5.7	11.1	24.1	9.5	14.1	23.3
Exports (gs, USD)	% yoy	-7.9	17.9	9.5	10.7	24.0	42.6	7.5	13.2	27.0 ^e
Imports (gs, USD)	% yoy	-19.1	18.9	14.1	4.9	28.7	31.3	20.4	22.0	34.1 ^e
Current account	USD bn	0.9 ^o	1.2 ^{oo}	1.4	3.1	2.9	6.9	2.5	-1.6	-6.2 ^e
Current account	% GDP	2.9 ^o	3.8 ^{oo}	3.7	7.6	5.9	10.6	2.9	-1.5	-4.4 ^e
FDI (net)	USD bn	0.5	0.6	0.8	0.7	1.4	1.7	6.5	5.3	9.0 ^e
International reserves	USD bn	1.09	1.48	3.09	4.42	6.94	9.52	19.39	22.26	32.48
Fiscal balance'''	% GDP	-2.1	-0.7	-1.9	0.8	-0.2	-3.0	-1.9	-0.9	-1.5 ^e
Total state debt	% GDP eop	61.0	45.3	36.5	33.5	29.0	24.7	17.7	15.0	12.6
External state debt (total)	% GDP eop	49.9	33.0	26.3	24.1	21.4	18.6	13.4	11.7	10.1
Monetary base	% yoy eop	39.3	39.9	37.4	33.6	30.1	34.1	53.9	17.5	46.0
Exchange rate	USD aop	4.13	5.44	5.37	5.33	5.33	5.31	5.12	5.05	5.05
Exchange rate	USD eop	5.07	5.44	5.30	5.33	5.33	5.31	5.05	5.05	5.05
Exchange rate	EUR aop	4.39	5.03	4.81	5.03	6.02	6.62	6.40	6.32	6.92
Exchange rate	EUR eop	5.20	5.10	4.67	5.53	6.66	7.22	5.97	6.65	7.42

SOURCES: Derzhkomstat, NBU, Ministry of Finance, own calculations

''' "Minus" denotes a consolidated fiscal deficit

^o The value of goods transferred to Russia according to the inter-governmental agreement reached in May 1997 on the Black Sea Fleet division totaling USD 726 m is not included

^{oo} The value of the aircraft complexes transferred to Russia as repayment of a gas debts according to the inter-governmental agreement reached in October 1999 totaling USD 274 m is not included.

Notes:

avg	average	ytd	year-to-date
cum.	cumulative	p.a.	per annum
mom	month on month change	eop	end of the period
qoq	quarter on quarter change	aop	average of the period
yoy	year on year change	gs	goods and services