

# Monthly Economic Monitor Ukraine

- In March the Parliament has gradually resumed its activity after a long break.
- Real GDP growth accelerated to 5.8% yoy between January and February thanks to strong industrial growth.
- The Government introduced restrictions on exports of sunflower seeds and oil.
- Another round of gas negotiations was completed between Naftogaz and Gazprom.
- The central budget was close to balance between January and February as the execution of expenditures remained low.
- The Government further increased social payments.
- Interest rates remain high due to very tight liquidity.
- Hryvnia appreciated slightly as the NBU appeared to shift to more flexible exchange rate management.

**No.4 (90)**  
**April**  
**2008**

**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%**

## Politics: The Parliament gradually returns to work

On March 6 the Verkhovna Rada resumed its work after the approval of non-binding resolution stipulating that the NATO membership for Ukraine should be decided in a plebiscite. However, during the month the Parliament did not make any policy decisions, instead concentrating on clearing backlog of technical matters. One of the few exceptions was the scheduling of early elections of the Kyiv Mayor for May 25, 2008. Candidates from all major parties are expected to participate in elections including Vitaliy Klichko supported in his second bid for mayoral post. Most of key political parties presented in the Parliament haven't officially announced their candidates yet.

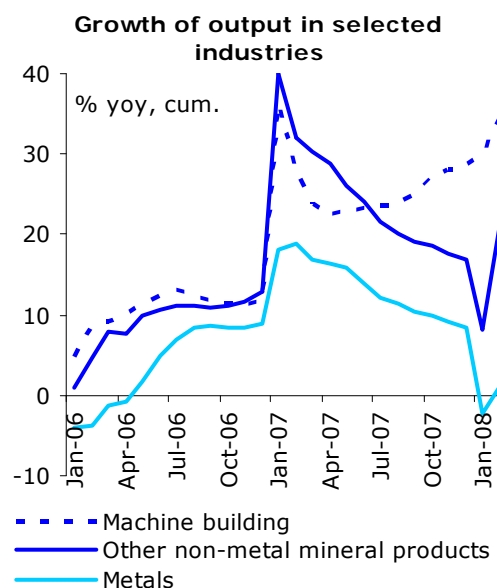
## Real economy: Real GDP grew at 5.8% yoy in February

The economic growth somewhat accelerated in February 2008 as compared to the previous period. According to the Derzhkomstat, in the first two months of the year real GDP increased by 5.8% yoy, primarily due to the higher growth of industrial production and stable development of transport and trade. In addition, the recovery of construction in February pared previous month losses in the sector, though the value added still fell by 4.4% yoy on cumulative basis.

Between January and February industrial output increased by 8.8% yoy. Traditionally high growth rates were observed in machine building and sectors supplying construction such as woodworking and production of other non-metal mineral products. Machine building posted good figures thanks to high external demand, in particular exports to the CIS countries, as well as domestic investment and consumption demand. The recent sharp increases in world steel prices positively affected metal production in February compensating for the drop in output in the previous month. Moreover, rubber and plastics industry and chemical production also displayed positive dynamics despite the increased costs of the imported gas.

## Sectoral trends: The Government set export quotas on sunflower seeds and oil

**Agriculture.** In March the government made a number of changes in the regulation of agricultural exports. First, existing export quotas on barley and wheat scheduled to expire in March were extended till April. Second, corn export quota was replaced with licensing and extended until July 1. Finally, sunflower seeds and oil export quotas were introduced for the period from March 22 until July 1. The quotas are set at 1000 tons for seed and 300 000 tonnes for oil. As before, the key motivation for export restrictions of grains and oilseeds remains fighting inflation. However, such a short-sighted policy makes the whole economy to bear welfare losses. Moreover, it deters potential investors from the country that proved to be an unreliable trade partner.



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**Energy.** On March 13, Russian gas monopoly Gazprom and Ukraine reached a preliminary agreement on natural gas supply. According to it, the price for Central Asian gas is preserved at USD 179.5 per thousand cubic meters (tcm) for 2008. However, Naftogaz Ukrainy agreed to pay USD 315 per tcm for Russian gas consumed at the beginning of the year with the option to conduct in-kind payment through transfer of gas kept in storage facilities. Gazprom agreed to supply 49.8 bn cubic meters (bcm) of Central Asian gas to Ukraine with at least 7.5 bcm supplied directly to industrial consumers and the rest to be distributed through Naftogaz Ukrainy. Before, imported gas was distributed through Ukgazenergo, the joint venture of Naftogaz and Rosukroenergo. New conditions are expected to be more beneficial for Naftogaz Ukrainy that may obtain the opportunity to improve its cash flow by selling gas at a healthy margin to industrial consumers. However, the deal is still to be finalized.

**Privatisation.** The State Property Fund (SPF) intends to suspend the privatisation of key companies to be sold this year: Odessa by-port plant, Ukrtelecom, Turboatom and six oblenergos. The SPF explained its decision by ruling of Antimonopoly Committee confirming their monopolistic status and the Presidential decree that *de-facto* prohibits privatization of state monopolies before the program of privatization is approved. At the same time, the Cabinet of Ministers released a decision to sell controlling stakes (60%+1) in four energy-generating companies: Donbasenergo, Zahidenergo, Dniproenergo and Centerenergo. The ambiguity in privatisation process could endanger the execution of privatisation plan set at UAH 8 bn.

**External sector: Current account deficit widened to 4.2% of GDP in 2007**

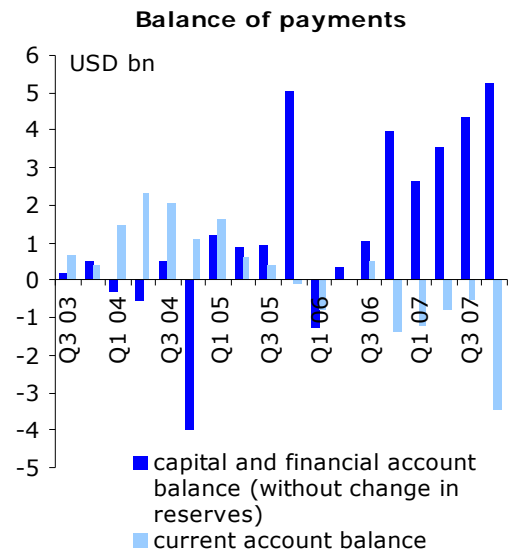
The current account deficit considerably widened in 2007, though it was comfortably covered by capital inflows. According to the NBU, the current account deficit reached USD 5.9 bn or 4.2% of GDP, up from 1.5% of GDP in 2006. A slight increase in surplus of service trade and higher inflow of current transfers were dwarfed by a commodity trade gap that doubled in size. The deficit of the trade in goods reached USD 10.6 bn, as import growth (36.9% yoy in dollar terms) continued to overtake the growth of exports (28.0%). Strong imports were backed by high investment and consumer demand, as well as rising costs of gas.

Record foreign capital inflows were registered in 2007. The capital and financial account surplus increased fourfold to USD 15.8 bn. The FDI net inflows reached USD 9.2 bn, with 37.9% of this amount invested in the financial sector. Flows from foreign borrowing almost doubled and reached USD 14.9 bn, including USD 9.7 bn in the second half of the year despite volatile world financial markets. However, significant downside risks remain for 2008, as in case of further aggravation of the crisis foreign funding can be cut off, adversely affecting Ukraine's external stability.

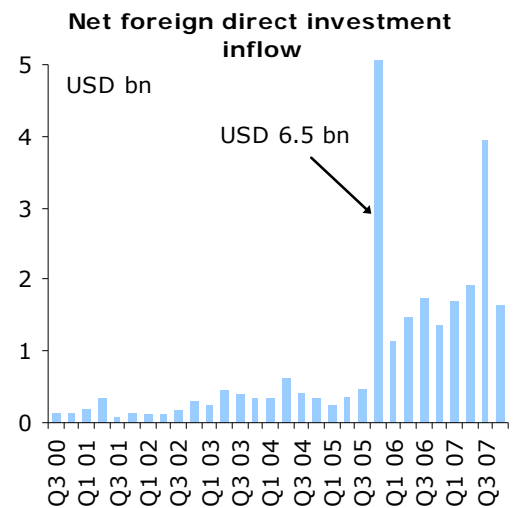
The Derzhkomstat reported that in January 2008 the exports of goods increased by 14.0% yoy in dollar terms, while imports excluding gas grew by 27.9% yoy. The Derzhkomstat didn't publish data on gas imports that accounted for around 20% of imports last year due to dispute over gas supplies to Ukraine. The deceleration of export growth rate should be attributed primarily to slower ferrous metal exports at the beginning of the year. As world steel prices are on the rise, metal exports are expected to rebound in February.

**Fiscal policy: The central budget was close to balance**

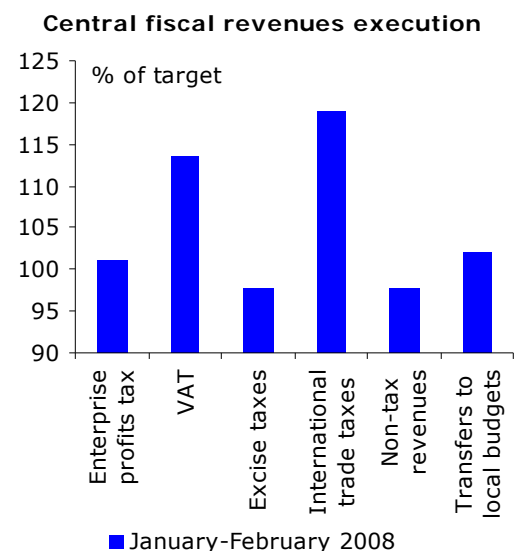
Between January and February central fiscal revenues were executed at 107.7% of the target thanks to high tax revenues. In particular, VAT revenues were over-executed by 13.6% due to the prohibition of non-cash tax payments and continuation of anti-smuggling campaign. The enterprise profit tax revenues and import duties were also 1.1% and 22.2% higher than the plan, respectively. On the other hand, receipts from excise and rent payments were lower than expected. The execution of central fiscal expenditures somewhat



Source: NBU



Source: NBU



Source: State Treasury reports

improved but remained low at 89.6% of the plan. However, social protection expenditures and transfers to local budgets showed traditionally high execution rates (97.9% and 94.9% of the plan, respectively). As a result, the central budget was almost balanced with central fiscal surplus at UAH 116 m or 0.1% of GDP.

**Social policy: Pensions increased to the subsistence minimum**

In March the Cabinet of Ministers approved the resolution introducing additional social assistance payment to certain groups of pensioners, bringing total pension payments to the subsistence minimum level set for individuals that lost ability to work (UAH 481 in April). Besides, the Government changed the minimum survivor's benefits to take into account the number of dependents. As a result, pension payments to around 1.4 m pensioners will be increased starting from April. However, the resolution does not provide funding of these payments apart from current allocations for welfare assistance and pension payments. The higher minimum pension payments might increase already high inflationary pressure. Therefore, the Government clearly indicated priority of social policy over the anti-inflationary measures.

**Monetary policy: Interest rates remain high**

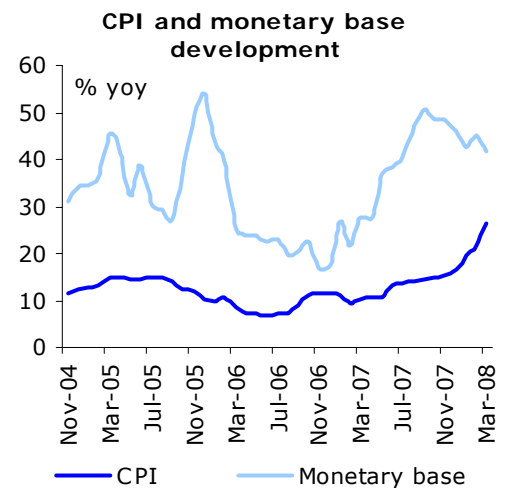
Monetary base increased by 41.4% yoy and money supply by 52.8% yoy in March. Given more restrictive monetary policy, the accumulation of government funds at the NBU and limited capital inflows, liquidity remained scarce supporting inter-bank lending rates at high levels. While at the beginning of the month money market eased a little with rates dropping to 5-6%, for next two weeks rates remained in 10-20% range forcing some banks to request refinancing from the NBU or sell US dollars to improve hryvnia liquidity. If interest rates remain high long enough, monetary policy may bring some success in limiting inflation, but with the risk of slowing real GDP growth.

In March, consumer prices jumped by 26.2% yoy. High inflation expectations, sharp increases in meat and fruit prices caused the acceleration of inflation. The next round of increases in social payments in April will add demand pressure on prices in the next months. On the other hand, the expanded price regulation powers of the local authorities may temporarily slow consumer prices growth. It is expected that inflation decelerates in the second half of the year given good harvest season.

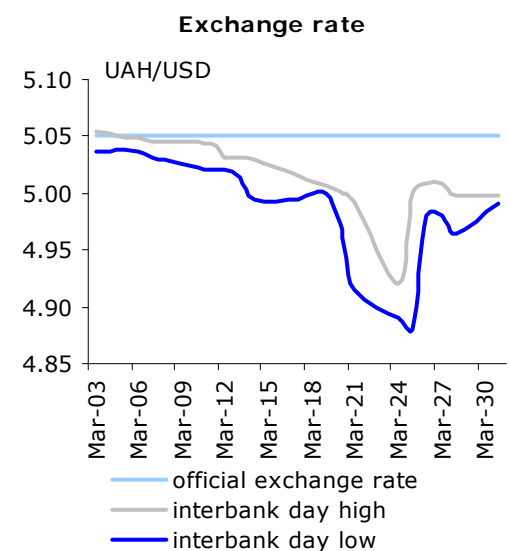
**Financial markets: Hryvnia slightly strengthened against the US dollar**

**Exchange rate.** High supply and limited demand for foreign currency caused steady appreciation of hryvnia relative to US dollar during March. USD/UAH inter-bank exchange rate hit bottom on March 25, reaching level of UAH 4.88 per USD unseen since 1999, while the NBU steered clear of the market, assuming a non-interventionist stance. Though lack of hryvnia liquidity contributed to US dollar decline, irregularities in gas import payments and panic on the retail market seem to be the main reasons behind exchange rate movements. After the NBU bent the rules slightly to allow US dollar purchases for gas import without signed contracts, hryvnia returned to 4.98-5.00 UAH per USD range. Overall, the NBU appears to abandon the 5.00-5.06 exchange rate band in favour of a more flexible exchange rate regime, although more information about the concrete shape of the new framework is not yet available.

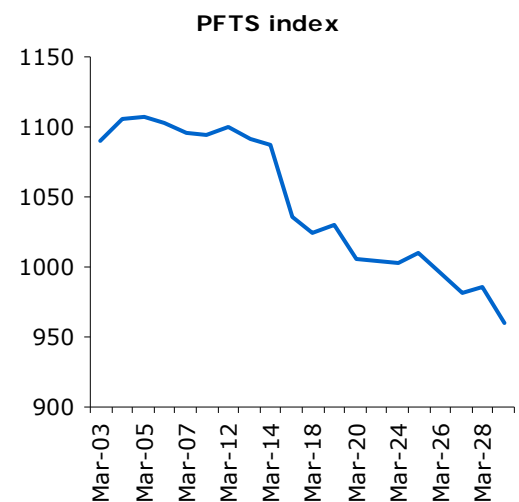
**Stock market.** In March the main Ukrainian stock market index PFTS dropped by 12% in line with stock market declines in the US, Asia and Europe. Due to the looming recession in the US, demand for risky investments decreased and foreign investors began to exit Ukraine's market. The correction on commodities markets also contributed to Ukrainian stock market decline after sell-off of energy and metallurgy stocks.



Source: Derzhkomstat



Source: Reuters Investor



Source: PFTS



Economic Trends		Q3 06	Q4 06	Q1 07	Q2 07	Q3 07	Q4 07	Dec	Jan	Feb	Mar
GDP growth (real)	% yoy	6.9	9.5	8.0	7.9	6.4	...	7.3	4.9	6.7	...
GDP growth (real)	% yoy cum.	6.1	7.1	8.0	7.9	7.3	7.3	7.3	4.9	5.8	...
Industrial production (real)	% yoy cum.	5.5	6.2	12.5	11.8	10.7	10.2	10.2	5.7	8.8	...
Agricultural production (real)	% yoy cum.	-2.8	0.4	5.0	6.3	-5.1	-5.6	-5.6	0.0	0.7	...
CPI	% yoy eop	9.1	11.6	10.1	13	14.4	16.6	16.6	19.4	21.4	26.2
PPI	% yoy eop	10.7	14.4	17.9	20.6	19.6	23.3	23.3	23.3	25.6	31.8
Exports (USD)***	% yoy cum.	10.7	13.2	32.4	32.4	27.3	27.4	28.4"	14.0"	...	...
Imports (USD)***	% yoy cum.	19.8	22.0	32.0	33.2	31.5	34.8	34.7"	27.9`	...	...
Merchandise trade balance	USD bn cum.	-2.93	-5.19	-1.74	-3.43	-6.12	-10.6	11.42"	...	...	...
Current account	USD bn cum.	-0.32	-1.62	1.21	-1.98	-2.47	-5.92	x	x	x	x
Current account	% GDP, cum.	-0.4	-1.5	-4.6	-3.4	-2.5	-4.2	x	x	x	x
Gross international reserves	USD bn eop	19.1	22.3	22.9	25.9	30.6	32.5	32.5	31.8	32.5	33.2
Monetary Base	% yoy eop	20.3	17.5	27.7	38.4	50.6	46.0	46.0	42.7	44.9	41.4
Lending rate on UAH credits **	% pa, aop	14.6	15.1	14.0	13.9	13.7	14.0	14.4	13.9	14.6	15.2
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
Exchange rate (official)	EUR aop	6.43	6.51	6.62	6.81	6.93	7.31	7.36	7.42	7.63	7.81

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

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

` January imports figures exclude gas due to pricing dispute

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	-5.2
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	27.4
Imports (gs, USD)	% yoy	-19.1	18.9	14.1	4.9	28.7	31.3	20.4	22.0	34.8
Current account	USD bn	0.9 °	1.2 °°	1.4	3.1	2.9	6.9	2.5	-1.6	-5.9
Current account	% GDP	2.9 °	3.8 °°	3.7	7.6	5.9	10.6	2.9	-1.5	-4.2
FDI (net)	USD bn	0.5	0.6	0.8	0.7	1.4	1.7	6.5	5.3	9.2
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	-1.1
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

° 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

°° 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:

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