

Monthly Economic Monitor Ukraine

**No.7 (93)
July
2008**

- The questions on formal existence of the coalition appeared after two members of the Parliaments left it.
- Between January and May real GDP increased by 6.4% yoy backed by acceleration in trade and manufacturing.
- The long-awaited State Privatisation Program for 2008-2012 was adopted in the first reading.
- In the first quarter current account deficit widened to USD 3.6 bn due to rapid growth of commodity imports.
- In May the central fiscal surplus reached 0.5% of GDP as revenues continue to exceed targets.
- Consumer price inflation decelerated to 29.3% yoy in June thanks to considerable slowdown in food prices.
- The stock market declined by 33.8% in the first half of 2008.

Population: 46.4 m
Industry/GDP: 32%
Agriculture/GDP: 7%
Investment/GDP: 27%
Exports to: Russia 26%, EU 28%
Imports from: Russia 28%, EU 37%

Politics: The existence of coalition is under question

On June 6, two deputies left the coalition bringing the number of coalition members to 225 and thus leaving it without the previous thin majority in the Verkhovna Rada. As a result, questions on formal existence of the coalition appeared. According to the legal opinion by the Ministry of Justice, the coalition has been formed by parliamentary factions and individual deputies may leave coalition only by leaving their faction as well. Both President and Prime-Minister of Ukraine support this position and claim that coalition is legally still intact. However, Verkhovna Rada remained in the standstill. Meanwhile, the opposition Party of Regions tried to start talks on forming new coalition and dismissing the Cabinet of Tymoshenko. It also asked the Constitutional Court to interpret relevant constitutional provisions. On June 24, leaders of factions that formed the coalition pledged to renew the effective work of the Parliament during the next week. In general, there are several possibilities for future developments including the preservation of the ruling coalition, possibly with two new coming deputies, reformatting of the coalition, or even pre-term elections.

Real economy: Real GDP grew by 6.4% yoy in the first five months

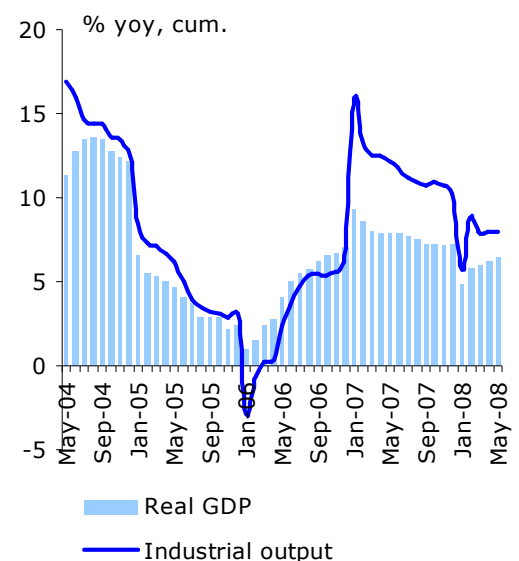
Economic growth continued to accelerate gradually, although it still remained slower than a year before. According to the Derzhkomstat, in the first five months of the year the real GDP increased by 6.4% yoy, to a large extent thanks to some acceleration in trade, manufacturing and extractive industry. At the same time, growth of value added in agriculture remained stagnant at 0.4% yoy, and the contraction of construction persisted.

Between January and May, the industrial output increase was 8.0% yoy, as the deceleration of growth in production and distribution of electricity, gas, and water was compensated by faster development of other sectors. In particular, manufacturing slightly accelerated to 8.8% yoy as metal production experienced a higher growth rate under favourable market conditions. At the same time, the growth in other industries slowed as financing became more scarce and expensive.

Sectoral trends: State Privatization Program for 2008-2012 was passed in the first reading

Privatisation. In June, the Verkhovna Rada passed the Law on the State Privatization Program for 2008-2012 in the first reading, making an important step in unblocking privatization process in the country. The Program sets new priorities for privatization and foresees the facilitation of the privatization process. If adopted, the program will remove major obstacle to large-scale privatization. Such privatization is necessary to fulfill privatization plan for 2008 as

Real growth rates of GDP and industrial production



Source: Derzhkomstat

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privatization revenues reached only UAH 295 m or 3.3% from the planned amount over the first five months of the year.

Meanwhile, the controversy around the Head of the State Property Fund (SPFU) continued. The coalition nominated a new candidate for this position, Andrey Kozhemyakin (BYUT), but failed to remove current head of SPFU from the office.

Energy. In the end of June, Prime Minister Yulia Tymoshenko has come to a verbal agreement with Russian Prime Minister Vladimir Putin regarding the gradual rise of prices on Turkmen gas imported from Russia instead of one-stage almost doubling of prices expected beforehand. However, the countries of Central Asia insist on an increase in prices up to the average European price level, explaining this decision by constantly increasing volumes of gas consumption in the EU, the most beneficial buyer of gas. Thus, future price on imported gas for Ukraine remains non-defined.

Telecommunications. The controversy over the authority of the Cabinet of Ministers (CMU) to make appointments to the national regulatory bodies renewed. At the end of May, the Cabinet of Ministers (CMU) allotted new head and staff of the National Commission for the Regulation of Communications (NCRC), but in June the President suspended the decision. This situation resembles the year 2007 when the President suspended appointments to the NCRC by Yanukovych Government. The uncertainty over the NCRC members ultimately hurts the regulator's efficiency and thus the development of the telecommunications sector.

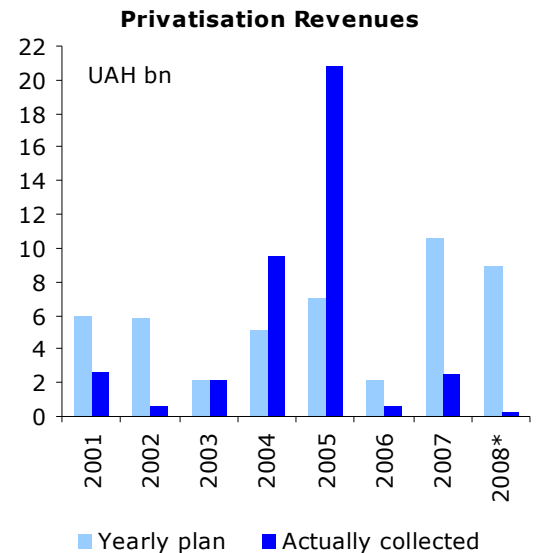
In June, new maximum tariffs for universal post services became effective. Tariffs for delivery of letters and other mailings within Ukraine and on parcels up to 10 kg within the CIS were raised by 40% on average. This measure was explained by the non-profitability of these services and necessity to adjust to higher input costs.

Agriculture. The low veterinary standards for dairy products in Ukraine prevent dairy exports to the EU. As a first step in removing this barrier, in 2007 Ukraine received the EU approval of residue monitoring plans for milk. In June 2008 sanitary inspectors from the EU Food and Veterinary Office visited selected Ukrainian dairy farms and milk processing enterprises to check the production process. A positive outcome of this mission would allow Ukrainian dairy companies to apply for permission to export dairy to the EU in the nearest years. However, the probability of positive result is rather low since Ukrainian dairy industry still needs a lot of improvements to meet the EU standards. Nevertheless, such inspections will stimulate positive changes in Ukrainian dairy production and create export potential to Ukrainian dairy industry.

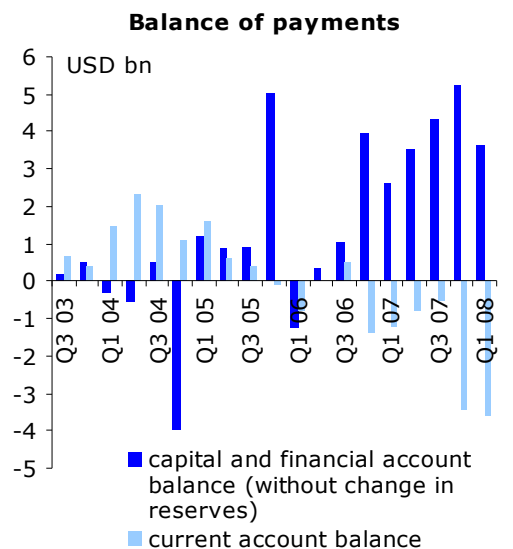
External sector: Current account deficit widened to USD 3.6 bn in the first quarter of 2008

The current account deficit widened significantly in the first quarter of 2008. According to the NBU, the deficit reached USD 3.6 bn or 9.6% of GDP, and tripled as compared to the same period in 2007. The expansion is attributed to the surge of commodity trade deficit against the background of high imports. Between January and March imports of goods increased by 45.1% yoy in dollar terms due to both higher import prices, especially for energy materials, and strong internal demand. In particular, imports of passenger cars and spare parts increased by 80% stimulated by growing consumer demand for durable goods. At the same time, exports of goods grew by 28.5% yoy partly due to high world prices on metals and chemicals.

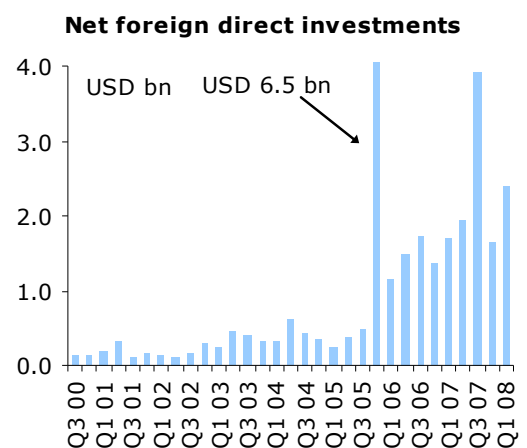
High foreign capital inflows covered the most of the current account deficit. In particular, foreign direct investments inflows increased and reached USD 2.4 bn in the first quarter. The lion share of inflows was directed into banking sector, followed by construction. In addition, medium- and long-term capital inflows were at USD 3.2 bn, with increasing role of real sector borrowing. The borrowings of banking sector considerably decelerated against strong base in 2007 due to international financial turmoil and restrictive domestic regulations.



Source: State treasury of Ukraine, SPFU
Note: * as of June 16, 2008



Source: NBU



Source: NBU

Fiscal policy: The central fiscal surplus reached UAH 1.7 bn or 0.5% of GDP

The over-execution of central fiscal revenues continued thanks to high tax receipts. Between January and May, the revenues were executed at 111.3% of the target. In particular, strong growth of profits boosted by high inflation allowed the State Tax Administration to collect 12.5% more than projected revenues from enterprise profit tax. The VAT revenues were over-executed by 12.7% thanks to 41.8% higher than planned collections of VAT on imports, while the VAT paid on domestic production remained 3.7% lower than projected. At the same time, the Government increased VAT refunds by UAH 4.6 bn or 50.5% from planned amount. The execution of central fiscal expenditures continued to improve gradually and reached 94.7% of the target. Still, the central fiscal balance was in surplus at UAH 1.7 bn or 0.5% of GDP.

Social policy: Real wages continue growing

Between January and May real wages increased by 11.2% yoy, which is somewhat slower than last year growth at 14.4% yoy. The average wage in May reached UAH 1774. As in the previous year, public sector employees including those working in education, health care, culture and sports enjoyed the fastest growth of real wages, mostly due to increase in minimum wage and the implementation of the second stage of the Unified Tariff Scale in the end of 2007 that increased differentiation in wages. The wages in these sectors are likely to spur once again at the end of the year after the implementation of the third stage of the Unified Tariff Scale planned for November 2008. Also, the agricultural sector demonstrated high real wage growth at 17.4% yoy, though the level of wages still did not catch up to other sectors staying at UAH 1050 in May.

Monetary policy: Inflation decelerated to 29.3% yoy

In line with expectations, in June consumer inflation decelerated to 29.3% yoy marking the first downward movement after fifteen months of upward trend. Seasonal effects, cooling in consumer demand and administrative pressure contributed to this deceleration.

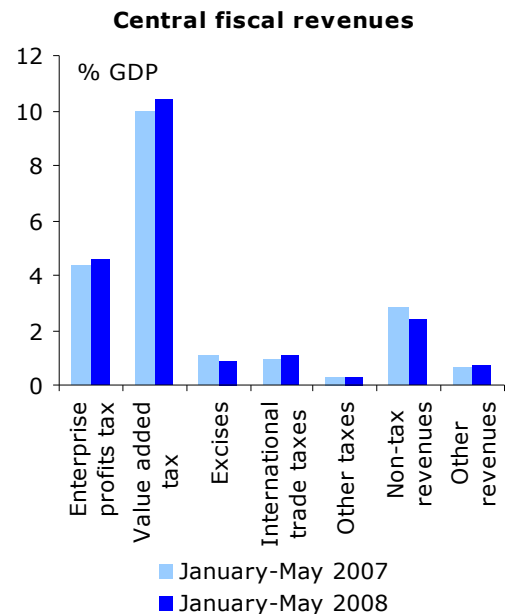
Monetary base increased by 38.9% yoy and money supply by 48.1% yoy in June. The volume of correspondent accounts increased by 11.1% up to UAH 17.8 bn due to a decrease of the Government deposits at the central bank and the NBU interventions on inter-bank exchange market. In total, the NBU purchased USD 1042 m in June. Though, liquidity in the inter-bank market remained limited contributing to the credit market cooling. However, the volatility on the market declined substantially and inter-bank rates remained below 20% over the month.

Financial markets: Stock market continued to plunge

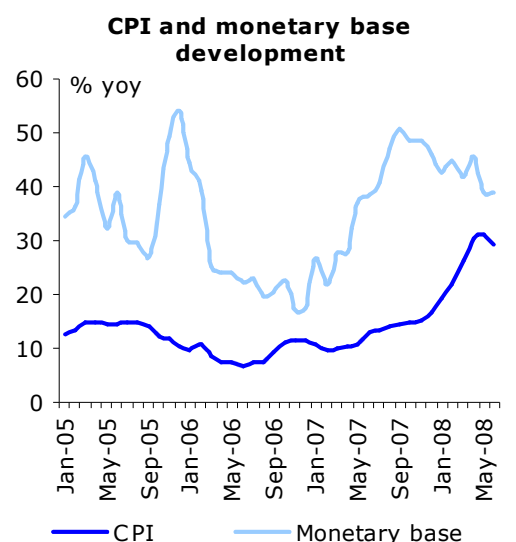
Stock market. The stock market in Ukraine continued falling. The PFTS index dropped by around 14% in June and by 34% in the first two quarters. This substantial decline could be attributed to both external and domestic factors. In addition to low appetite for risk in the world, political instability in Ukraine forced both residents and foreigners to take wait-and-see attitude. Besides, tougher monetary policy constrained liquidity in banking system and cut down in crediting that negatively influenced stock quotations.

State debt. The Ministry of Finance started road show for planned issue of five-year Eurobonds amounting to USD 500 m. It will be lead by the consortium of BNP Paribas, JP Morgan and Standardbank. Fitch Ratings assigned a BB- rating to the future issue. However, the terms and yield for the placement are not announced yet as the Ministry is waiting for the most favorable conditions on debt market.

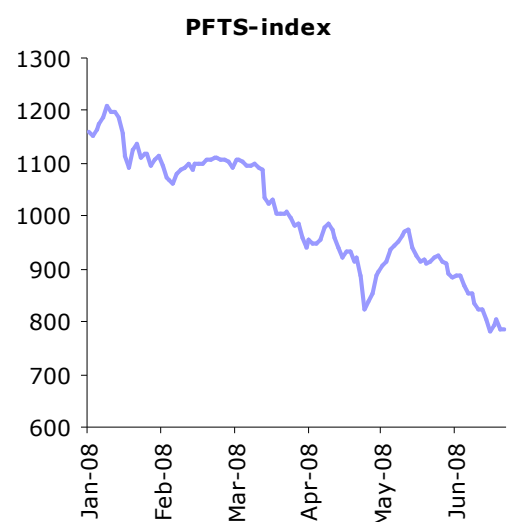
At the same time, the Ministry is not very active on domestic market despite its declared intention to increase the share of domestic borrowings. Due to unattractive conditions of placement, in June the Ministry managed to place additionally only UAH 37.2 m of five-year domestic bonds maturing in 2010-2011 with 7.9% yield p.a.



Source: The State Treasury reports



Source: Derzhkomstat, NBU



Source: PFTS

Economic Trends		Q4 06	Q1 07	Q2 07	Q3 07	Q4 07	Q1 08	Mar	Apr	May	Jun
GDP growth (real)	% yoy	9.5	8.9	8.6	6.2	7.4	...	6.5	6.7	7.2	...
GDP growth (real)	% yoy cum.	7.1	8.0	7.9	7.3	7.6	...	6.0	6.2	6.4	...
Industrial production (real)	% yoy cum.	6.2	12.5	11.8	10.7	10.2	7.8	7.8	8.0	8.0	...
Agricultural production (real)	% yoy cum.	0.4	5.0	6.3	-5.1	-5.6	0.2	0.2	0.4	0.2	...
CPI	% yoy eop	11.6	10.1	13	14.4	16.6	26.2	26.2	30.2	31.1	29.3
PPI	% yoy eop	14.4	17.9	20.6	19.6	23.3	31.8	31.8	37.5	39.4	43.7
Exports (USD)***	% yoy cum.	13.2	32.4	32.4	27.3	27.4	28.5	28.5"	30.9"
Imports (USD)***	% yoy cum.	22.0	32.0	33.2	31.5	34.8	45.1	45.2"	50.3"
Merchandise trade balance	USD bn cum.	-5.19	-1.74	-3.43	-6.12	-10.6	-4.3	-5.0"	-7.4"
Current account	USD bn cum.	-1.62	1.21	-1.98	-2.47	-5.92	-3.6	x	x	x	x
Current account	% GDP, cum.	-1.5	-4.6	-3.4	-2.5	-4.2	-9.6	x	x	x	x
Gross international reserves	USD bn eop	22.3	22.9	25.9	30.6	32.5	33.2	33.2	33.3	34.4	35.4
Monetary Base	% yoy eop	17.5	27.7	38.4	50.6	46.0	41.4	41.4	45.6	38.8	38.9
Lending rate on UAH credits **	% pa, aop	15.1	14.0	13.9	13.7	14.0	14.6	15.2	16.9	17.5	17.3
Exchange rate (official)	USD aop	5.05	5.05	5.05	5.05	5.05	5.05	5.05	5.05	4.99	4.85
Exchange rate (official)	EUR aop	6.51	6.62	6.81	6.93	7.31	7.56	7.81	7.96	7.76	7.54

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	544.2	712.9
Nominal GDP	USD bn	31.6	31.3	38.0	42.4	50.1	65.0	86.2	107.8	141.2
GDP growth (real)	% yoy	-0.2	5.9	9.2	5.2	9.6	12.1	2.7	7.3	7.6
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:

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