

Monthly Economic Monitor Ukraine

**No.8 (94)
August
2008**

- The parliament closed its second session with old State Budget.
- Between January and June real GDP growth slightly decelerated to by 6.3% yoy as trade and manufacturing slowed.
- Long-distance fixed-line call tariffs were deregulated.
- In the first half of 2008 current account deficit widened to USD 6.7 bn due to rapid growth of commodity imports.
- The net FDI inflow reached USD 5.1 bn between January and June due to continued mergers and acquisitions in the financial sector.
- In June the central fiscal deficit amounted to 0.3% of GDP.
- Consumer price inflation slowed to 26.8% yoy in June as vegetable prices return to their 2007 level.
- The NBU Council changed its exchange rate benchmark.

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 Parliament closed its second session

On July 11, 2008 the Verkhovna Rada closed its second session. At the closing meeting speaker Arseniy Yatsenyuk criticised inability of the Ukrainian parliament to pass a number of urgent bills that allegedly were critical for the country's development. At the same time, certain achievements were noted including the ratification of the WTO accession package, preliminary approval of constitutional amendment to withdraw parliamentary immunity and the reform of the public procurement that removed Tender Chamber from the process.

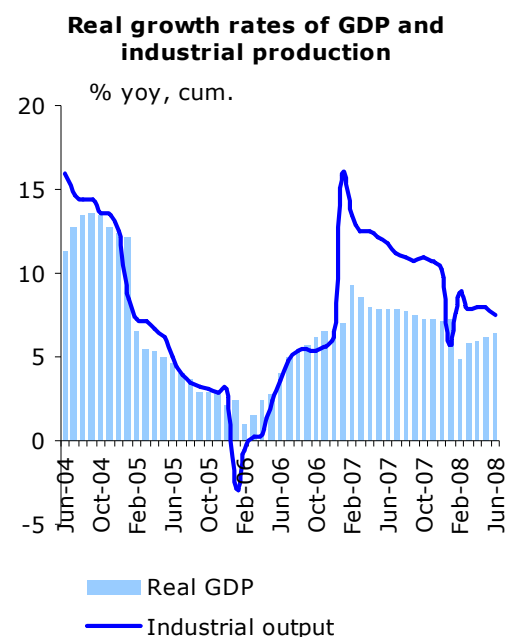
However, the Rada failed to agree on single version of amendments to the State Budget. Drafts were introduced by the President, the Cabinet of Ministers and the opposition communist faction. In the end, the Verkhovna Rada sent the drafts to repeat first reading with the hope to return to the budget amendments in autumn.

Though, in the end of July the Verkhovna Rada displayed rare unity in reaction to floods that affected Western Ukraine. It almost unanimously appropriated funds for relief in the affected regions. However, even this decision was not without its portion of partisan squabbling as the President and Prime Minister submitted separate drafts.

Real economy: Real GDP grew by 6.3% yoy in the first half of 2008

The real GDP growth slightly decelerated in June in comparison with May 2008. According to the Derzhkomstat, the real GDP grew at 6.3% yoy in the first half of the year, 0.1 percentage point below the previous period growth rate. The deceleration took place thanks to noticeable slowdown in trade, manufacturing, and agriculture while mining, and transport supported growth. Industrial production growth decelerated to 7.5% yoy between January and June, mainly due to some slowing in metallurgy and chemical industry. At the same time, machine building, mineral non-fuel mining, and production and distribution of electricity, gas, and water displayed healthy growth.

On the demand side GDP growth became even more consumer-centred as the real final household consumption grew at 22.0% yoy in the first quarter of 2008 as compared to 19.1% yoy increase in the first quarter of 2007. The rapid growth in household consumption was stimulated by growing real incomes and disincentive to save money created by existence of negative real interest rates. At the same time, the uncertainty related to mounting inflationary pressures and confusing political environment, and growing financing costs caused the investments to slow down sharply in the first quarter of 2008. The real growth rate of gross fixed capital formation decelerated to 14.7% yoy against 25.9% yoy a year before.



Source: Derzhkomstat

Institute for Economic Research and Policy Consulting
 Reyarska 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: Long-distance calls were deregulated

Telecommunications. The National Commission for the Regulation of Communications (NCRC) approved new maximum tariffs for local calls and revoked state regulation of tariffs for fixed-line long-distance calls. The regulation is effective since July. This decision will increase commercial independence of Ukrtelecom allowing it to compete with mobile operators more successfully. However, it is unlikely that Ukrtelecom could regain lost market share in long-distance calls and thus increase its share price, which in turn would contribute to its sales price in case of privatization.

Transport. In July 2008 rail transportation tariffs continued to grow, while railway reform did not show any progress. Freight transportation tariffs were increased by 3%, while lease payments for Ukrzaliznytsia’s freight cars were also revised upwards by 9.4-216.7%. Thus, the Government attempted to increase Ukrzaliznytsia’s revenues, which can be transferred to the state budget or invested in rolling-stock modernization. However, possible increase in private freight cars numbers and partial reorientation to road transport are likely to limit additional revenues.

Utilities. On July 16 the Cabinet of Ministers approved rules of operation for the State Housing Inspection created in June as a special division in the Housing and Utilities Ministry. The new body will regulate utilities market in the spheres of central water supply and drainage systems, including pricing and tariff setting. However, the intentional best practice shows that it would be better to establish independent regulatory agency, free from political interference both from central ministries as well as from local governments and other authorities, to ensure transparent decision-making and efficient enforcement.

External sector: Current account deficit reached USD 6.7 bn in the first half of the year

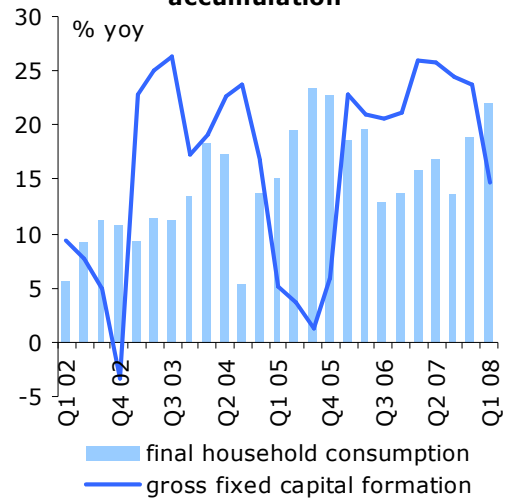
According to the NBU preliminary estimates, in the second quarter current account deficit shrank to USD 2.8 bn as compared to USD 3.6 bn in the first quarter of 2008. Still, cumulative balance for the first two quarters reached USD 6.7 bn or 7.7% of GDP, that is 3.4 times higher than in the first half of 2007. The reduction of deficit in the second quarter can be attributed to the more balanced growth of external trade with lesser gap between export and import growth rates. In particular, monthly commodity trade deficit shrank to USD 0.5 bn in June from USD 2 bn in April. Despite this positive sign, six-month commodity trade deficit remained high at USD 8 bn. Thanks to rising world prices for agricultural, chemical products and metals, merchandise exports grew by 40.5% yoy in dollar terms between January and June. Still, the sharp growth of commodity imports at 52.5% yoy continued attributable to the expansion of internal demand and increased energy prices.

Recovery of foreign capital inflows in the second quarter was enough to cover current account deficit and produce significant increase in reserve assets. Financial account surplus reached USD 9 bn in first half of 2008, while net FDI inflow increased to USD 5.1 bn. The FDI were concentrated in financial sector (63.2% of all FDI). At the same time, long-term external borrowing by banks grew only 10.1% yoy, while real sector loans and deposits by non-residents grew much stronger. This situation reflects more stringent liquidity constraints by banks, while real sector increasingly chooses to receive foreign funding directly.

Fiscal policy: Central fiscal balance turned to deficit in June and reached 0.3% of GDP

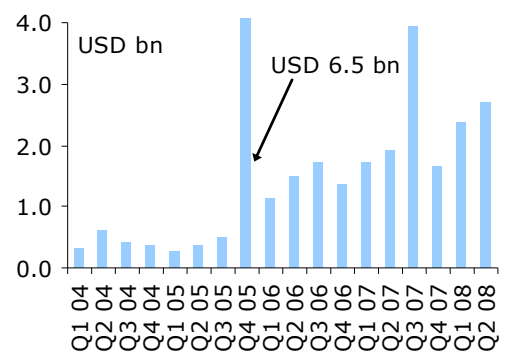
In the first half of 2008 central fiscal revenues were executed at 111.0% of the target. In particular, the enterprise profit tax revenue was at 17.0% above the plan due to strong corporate profits. The VAT revenues exceeded the target by 11.2% thanks to high collections of the VAT from imports. The central fiscal expenditures

Real final households consumption and gross fixed capital accumulation



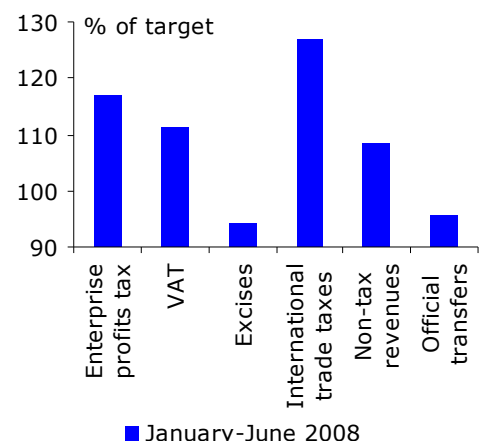
Source: Derzhkomstat

Net foreign direct investments



Source: NBU

Central fiscal revenues execution



Source: State Treasury reports

execution remained high at 94.5% of the target. In June the central fiscal balance turned into deficit at UAH 1.5 bn or 0.3% of GDP.

In the end of July the Parliament amended the State Budget. Central fiscal revenues increased by UAH 5.8 bn, which are to be received from the VAT and excises. The main part of additional funds will be spent for the liquidation of flood consequences (UAH 4.4 bn), the rest will be directed on agricultural sector support (UAH 1.4 bn).

Social policy: Pension increase will be paid as a special subsidy

The pensions were raised since July 1, 2008 by the decision of Cabinet of Ministers made in mid-July after the Verkhovna Rada failed to pass the State Budget amendments. In particular, the minimum pension payment was revised upwards by 13% to UAH 544. Some other types of pensions, including pensions of Chernobyl accident victims and retired military servants, were also increased. The pension increase was implemented as special subsidy instead of permanent pension increase, which will probably be approved later. This subsidies will be paid using the Pension Fund own funds, despite the legal requirement of paying such subsidies through the special central fiscal transfer to the Pension Fund. Also, minimum pension will be higher than minimum wage in the third quarter of 2008, which is economically unjustified policy.

Monetary policy: Inflation decelerated to 26.8% yoy

In July consumer inflation decelerated to 26.8% yoy from 29.3% in June indicating the first monthly decrease in price level (by 0.5% mom) since April 2006. Drop in vegetable prices to the July 2007 levels was the main driver of such decrease. Core inflation index that excludes the most of the seasonal and administratively regulated products from the basket grew by only 1.0% mom reflecting four months of deceleration in core inflation. However, core inflation decelerated significantly less than headline inflation reflecting large administrative and seasonal component in the headline inflation.

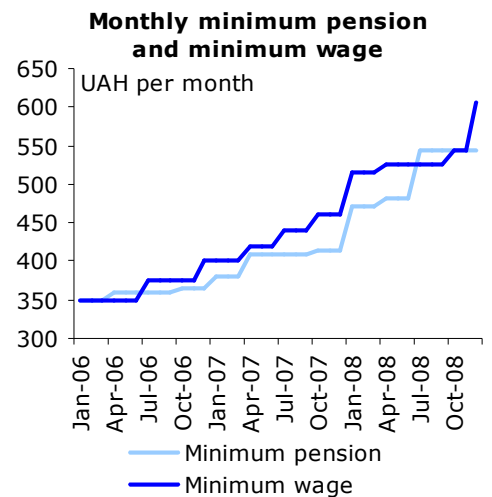
The NBU sharpened regulations to limit inflow of "hot" money from abroad. Under newly introduced reserve requirement, banks are required to deposit reserves equal to 20% of short-term (up to six months) loans and deposits by non-residents at separate account at NBU. The reserves are unremunerated. The measure will affect part of short-term external obligations (up to one-year) by the banking sector, which were at USD 12.3 bn by the end of the first quarter.

Monetary base increased by 41.6% yoy and money supply by 47.5% in July. Higher government spending and vast foreign exchange market interventions (USD 2.5 bn) caused higher liquidity and lower interest rates. Inter-bank interest rates remained in the single digits for the most of the month. Thus, the monetary conditions loosened.

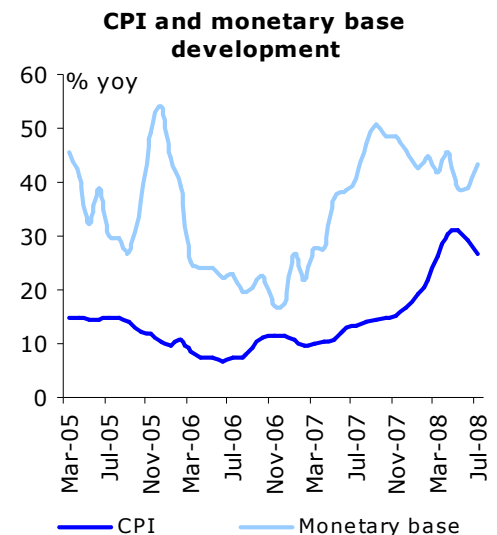
Financial markets: The NBU Council changed exchange rate benchmark

Exchange rate. The NBU council amended Guidelines for Monetary Policy for 2008. It changed official exchange rate forecast to 4.85±4% UAH per USD for the second half of 2008. Thus, the NBU Council forecasts UAH/USD exchange rate in 4.656-5.044 range. However, this forecast is not binding for the NBU Board, therefore exchange rate policy remains unclear.

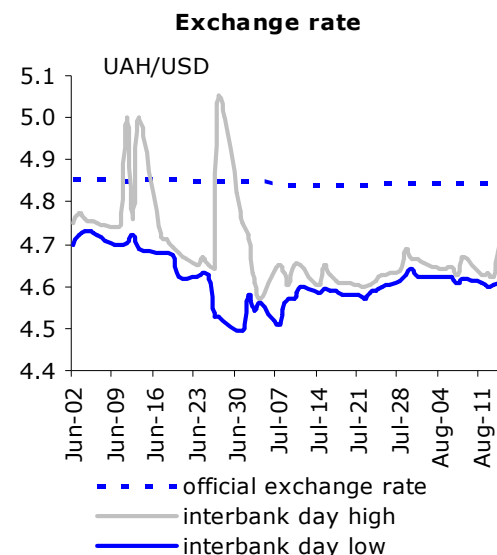
Financial services. According to 2007 Annual Report of Financial Services Commission, last year asset management companies and investments funds continued rapid growth, while growth in the non-state pension funds and insurance companies was somewhat less impressive. Assets under management increased by 138% in 2007 and comprised approximately 6% of the 2007 GDP by the year-end. Assets in non-state pension funds and insurance companies rose by 105.1% and 34.5% respectively. According to the S&P, Ukraine is the most capitalised "frontier" market, though it still has not reached regular emerging market status. Imperfect regulation is one of the obstacles for further non-bank financial sector development.



Source: State Budget Laws for 2006, 2007 and 2008, the resolution of the Cabinet of Ministers #654 from Jul.16, 2008



Source: Derzhkomstat, NBU



Source: Reuters Investor



Economic Trends		Q4 06	Q1 07	Q2 07	Q3 07	Q4 07	Q1 08	Q2 08	Mar	Apr	May	Jun	Jul
GDP growth (real)	% yoy	9.5	8.9	8.6	6.2	7.4	6.5	...	6.5	6.7	7.2	5.4	...
GDP growth (real)	% yoy cum.	7.1	8.0	7.9	7.3	7.6	6.5	...	6.0	6.2	6.4	6.3	...
Industrial production (real)	% yoy cum.	6.2	12.5	11.8	10.7	10.2	7.8	7.5	7.8	8.0	8.0	7.5	7.3
Agricultural production (real)	% yoy cum.	0.4	5.0	6.3	-5.1	-5.6	0.2	-0.3	0.2	0.4	0.2	-0.3	...
CPI	% yoy eop	11.6	10.1	13	14.4	16.6	26.2	29.3	26.2	30.2	31.1	29.3	26.8
PPI	% yoy eop	14.4	17.9	20.6	19.6	23.3	31.8	43.7	31.8	37.5	39.4	43.7	46.3
Exports (USD)***	% yoy cum.	13.2	32.4	32.4	27.3	27.4	28.5	...	28.5"	30.9"	35.8
Imports (USD)***	% yoy cum.	22.0	32.0	33.2	31.5	34.8	45.1	...	45.2"	50.3"	52.3
Merchandise trade balance	USD bn cum.	-5.19	-1.74	-3.43	-6.12	-10.6	-4.3	...	-5.0"	-7.4"	-8.8"
Current account	USD bn cum.	-1.62	1.21	-1.98	-2.47	-5.9	-3.6	...	x	x	x	x	x
Current account	% GDP, cum.	-1.5	-4.6	-3.4	-2.5	-4.2	-9.6	...	x	x	x	x	x
Gross international reserves	USD bn eop	22.3	22.9	25.9	30.6	32.5	33.2	35.5	33.2	33.3	34.4	35.5	37.9
Monetary Base	% yoy eop	17.5	27.7	38.4	50.6	46.0	41.4	38.9	41.4	45.6	38.8	38.9	41.6
Lending rate on UAH credits **	% pa, aop	15.1	14.0	13.9	13.7	14.0	14.6	17.2	15.2	16.9	17.5	17.3	17.1
Exchange rate (official)	USD aop	5.1	5.1	5.1	5.1	5.1	5.1	5.0	5.1	5.1	5.0	4.9	4.8
Exchange rate (official)	EUR aop	6.5	6.6	6.8	6.9	7.3	7.6	7.8	7.8	8.0	7.8	7.5	7.6

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