

# Monthly Economic Monitor Ukraine

**No.9 (95)  
September  
2008**

- Military conflict between Russia and Georgia was in the centre of political discussions in Ukraine in August.
- Between January and July real GDP growth accelerated to 6.5% yoy as good crop harvest boosted agriculture.
- Gas tariffs for households were increased.
- Crop harvest is estimated at up to 49 m tons, though with a high share of feed grain.
- Merchandise exports and imports grew at record pace in the first half of 2008.
- In July the central fiscal deficit remained at 0.3% of GDP.
- Government provided assistance to the flood victims.
- Consumer price inflation slowed to 26.0% yoy in August as seasonal goods limit price growth.

**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: Ukraine's position on Russian-Georgian conflict

After Georgian attempt on August 7 to resume control over the breakaway region of South Ossetia by force, Russia launched a military attack on Georgian territory. On August 26 Russia recognised the independence of Abkhazia and South Ossetia.

From the first days of the conflict Ukrainian President Victor Yushchenko made efforts to provide diplomatic assistance for ceasefire and direct negotiations between Georgia and South Ossetia.

Russian Black Sea Fleet ships based in Crimea participated in hostilities against Georgia. This caused concerns that Ukraine was unwillingly involved in the war. On August 13 Ukrainian President issued several decrees that required Russian Black Sea Fleet to provide more information on its movements. Russian authorities refused to observe the Presidential Decrees as contradicting to the Russian-Ukrainian international agreements.

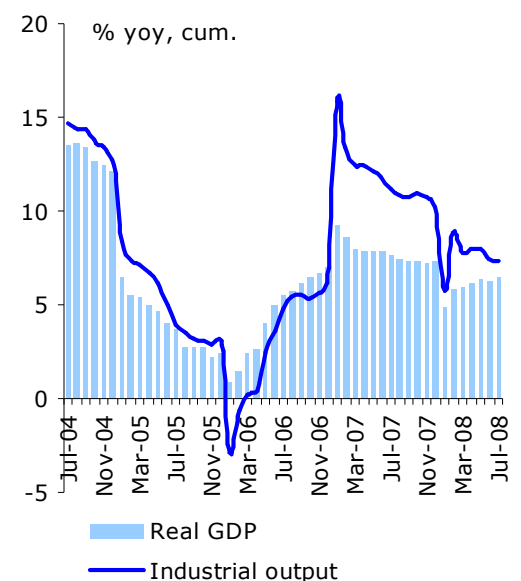
Initially neither the Prime Minister Tymoshenko, nor the leaders of Ukraine's parliamentary factions voiced publicly their views on the conflict. Later Yulia Tymoshenko supported the EU position on the conflict, while leader of the Party of Regions Victor Yanukovich supported Russian side and urged to recognize the independence of South Ossetia and Abkhazia. The position of Ukraine's political leaders corresponds to their foreign policy orientations, while according to the polls, Ukrainian society remains split in its opinions on the Russian-Georgian conflict

## Real economy: Real GDP growth accelerated in July thanks to agriculture

Real GDP grew by 6.5% yoy between January and July, that is 0.2 percentage points above growth rate for the first half of the year. This acceleration was caused mainly by the strong increase of value added in agriculture by 10.8% yoy due to good crop harvest. At the same time trade decelerated sharply to 11.8% yoy in the first seven months of the year, partly due to deceleration of retail trade against the background of slowing domestic demand. Also, the continuation of contraction in the construction sector caused ripples in the related industries. In particular production of building materials sagged as demand subsided. Though, the liquidation of flood consequences in the Western Ukraine may improve situation in construction in the coming months.

According to the Derzhkomstat, between January and July the industrial output increase by 7.3% yoy against 11.3% yoy rise in previous year. Effect of problems with access to financial resources and high inflation limited growth rates in industry. Only metal production and mining of non-energy materials shows acceleration of growth rates due to favourable situation on world markets.

**Real growth rates of GDP and industrial production**



Source: Derzhkomstat

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### Sectoral trends: Gas tariffs for households have increased for the first time since January 2007

Energy. In August the National Electricity Regulatory Commission (NERC) increased natural gas tariffs for population by 13-14% effective from September. The new tariff schedule preserves differentiation of tariffs based on the yearly volume consumed and the availability of the gas meter. It is the first increase in gas tariffs for households since January 2007. If the increases become more frequent, money collected will find its way to upstream gas extracting companies and encourage investors into the sector.

Agriculture. The Agriculture Ministry estimated grain production at 43 m tonnes by the end of August, 2008. It is almost twice as much as by August, 2007. The growth is largely attributed to comparatively high yields. The average yield of grain in 2008 is 3.45 tonnes/ha, that is 1.7 times more than a year before. Totally, Ukraine expects 48.7 m tonnes of grain in 2008, boosting exports. A grain export for 2008 is estimated at 22.6 m tonnes that is more than 4 times more in comparison with 2007.

However, increased production did not come with high quality. Large share of feed grain is explained by unfavourable weather conditions and low technological level and limited investments in Ukrainian agricultural sector. To secure necessary funding needed for further agricultural sector development transparent and predictable policy of Ukrainian government will be helpful.

Privatization. At the end of August Kyiv City Council expanded the list of objects for privatization from 78 to 258 enterprises. The expanded list includes a number of attractive objects such as airport "Kyiv" (Zhulyany), transport company "Kyivspetstrans", road maintenance company "Kyivautodor" and the majority stake in regional bread producer "Khlib Kyeve". The most controversial objects are local water and gas utilities. Some enterprises might be interesting for investors because they will be sold with the land plots in the prime locations. Obviously the planned massive sale of the city property will cause widespread discussion. However, according to the Ukrainian legislation, city property may be sold quite quickly without lengthy consultations.

### External sector: Trade expanded in the first half of 2008

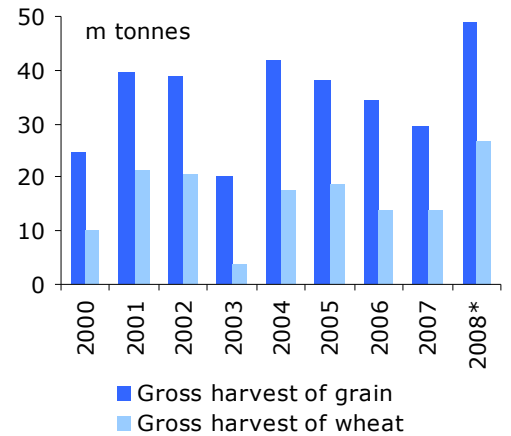
According to Derzhkomstat in the first half of 2008 merchandise exports grew by 40.7% yoy and imports by 55.3% yoy in dollar terms. Expansion in exports was mostly attributed to rise in export of iron that was 1.6 times higher than in a year ago, and revival in gasoline exports. Import growth was assured by increase in imports of energy products by 43.9% yoy, and of land transport excluding railway transport by 80.5% yoy. The reduction of tariff protection and high demand also boosted imports of meat and related products by 330.1% yoy, and of vegetables and roots by 397.2% yoy, though both from extremely low base.

In August Russia once again introduced restrictions for Ukrainian exports of animal-origin products, namely dried milk and cheese. This measure will cause a significant deceleration of exports of these products, negatively affecting producers, though increased domestic supply and lower prices will benefit consumers.

### Fiscal policy: Central fiscal deficit kept at 0.3% of GDP

Between January and July, the central fiscal revenues were 9.2% above the plan. Revenues from enterprise profit tax exceeded the target by 18.8% due to continued growth of corporate profits. The revenues from VAT on domestic production underperformed the target by 4.9%, but high collections from VAT on imports, which exceeded the target by 34.9%, compensated the shortfall and allowed overall VAT revenues to surpass plan by 8.0%. The execution of central fiscal expenditures continued to improve gradually and reached 95.9% of the target. Thus, in July the central fiscal deficit (general fund) reached UAH 1.6 bn or 0.3% of GDP.

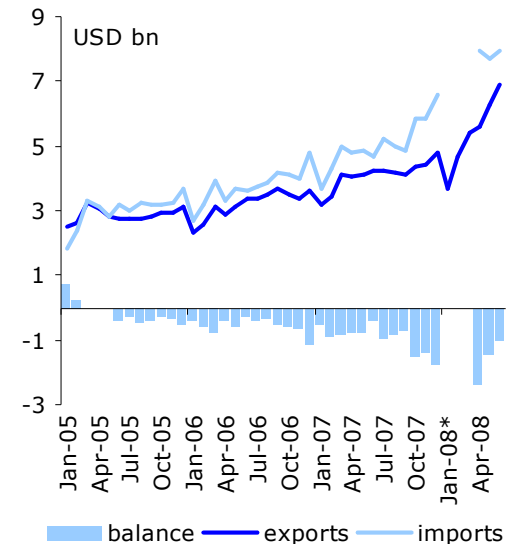
### Crop Production Development



Source: Derzhkomstat

\* Estimate by the Ministry of Agrarian Policy

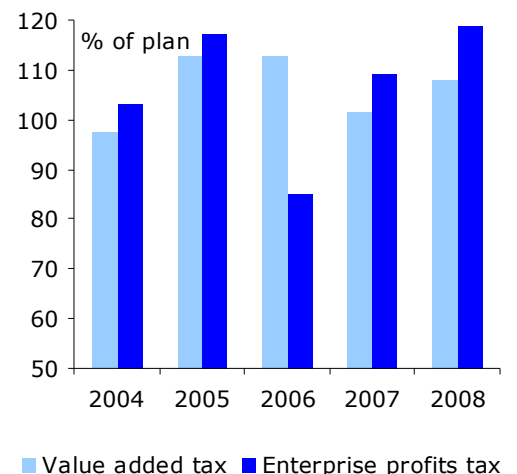
### Merchandise Trade



Source: Derzhkomstat

\* Natural gas import data not reported

### Key tax revenues for January-July



Source: State Treasury

**Social policy: Government provides assistance to the flood victims**

On July 31, 2008, the Parliament approved the State Budget Law amendments in order to foresee funds required for household assistance payments and infrastructure renovations in the Western regions of Ukraine suffered from the massive flood. The fiscal central expenditures were increased by UAH 4.1 bn. The state assistance to flood victims is paid in three instalments according to the lists compiled by district state administrations. The first two instalments provided emergency subsistence funds depending on the severity of flood damage, while the third one will be made only after accounting of losses. In particular, the households will be compensated for damaged and destroyed houses, loss of property etc.

Overall 31811 households are eligible to receive state assistance. By the end of August, all targeted households received first instalment and 88% received the second instalment. Government approved the tight schedule for infrastructure renovation and housing reconstruction. This plan may face some problems including the shortage of labour. To solve this problem, the State Employment Centres signed contracts with local authorities and other employers about provision of labour. As of end of August 6772 unemployed were occupied at public works.

**Monetary policy: Inflation decelerated to 26.0% yoy**

In August consumer inflation decelerated to 26.0% yoy. Low prices for fruit and vegetables thanks to good harvest helped to limit price growth. Core inflation also decelerated to 0.7% mom as inflation expectations continued to calm. However new round of wage and pension increases in September may endanger disinflation process in Ukraine.

Monetary base increased by 40.2% yoy and money supply by 44.3% in August. Liquidity in August was tighter than in July and interbank interest rates returned to double digits though they remained below 20%. Less extensive foreign exchange interventions (USD 1.2 bn) and tighter government spending may explain this situation.

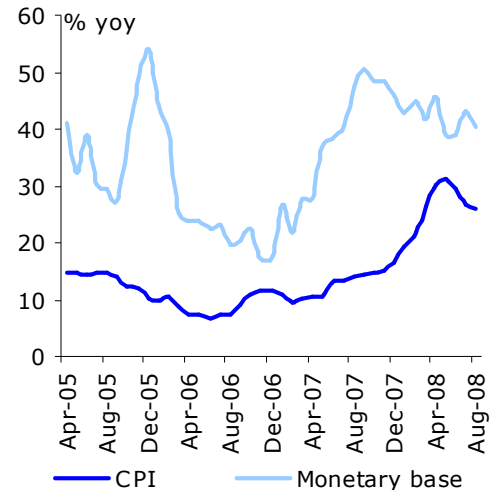
**Financial markets: Capital controls are challenged in the court**

Banking sector. Since August, 20% unremunerated reserve requirement for short-term foreign capital inflows (up to six months) became effective. On August 18 local court in Donetsk region issued order suspending this reserve requirement and prohibition of short-term local currency deposits for non-residents. However, the NBU intends to appeal this ruling and is likely to prevail. Validity of the Donetsk local court ruling is questionable as all challenges to the NBU regulations have to be filed in Kyiv administrative court. This case underlines the paramount importance of the establishment of efficient regulatory system for financial market development.

Stock market. In August the PFTS index continued its downfall and dropped by 18.5% to 532.1. From the beginning of the year the stock market in Ukraine slumped by 54.5%, which is one the highest losses for investors in the world along with Chinese market. As Ukrainian stock market growth is driven mainly by the investment strategy of foreign investment funds, the turbulence in global financial markets remains the main reason of PFTS index decline. Yet other factor is growing domestic political and macroeconomic risks.

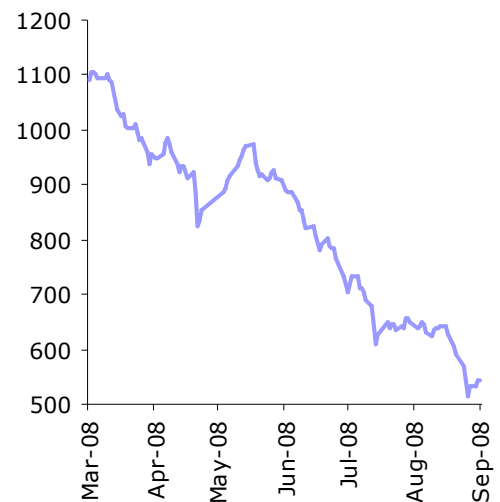
State debt. In August the Ministry of Finance gradually increased the offered yield on the five-year domestic state bonds maturing in 2010-2011 from 7.7-7.9% to 11.8-12.0% p.a. Such movement toward the investor expectations resulted in successful placement UAH 117.9 m state bonds with the average yield of 11.5% p.a. The Ministry of Finance also confirmed that will continue to increase liquidity of five-year issues maturing in 2010-2011 until it will reach UAH 1 bn for each issue.

**CPI and monetary base development**



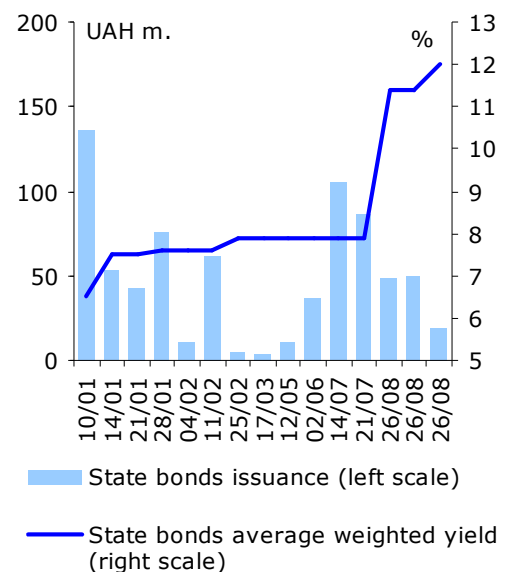
Sources: Derzhkomstat, NBU

**PFTS-index**



Source: PFTS

**Issuance and average yield of 2005-06 state bonds placement in 2008**



Source: NBU, Minfin



<b>Economic Trends</b>		<b>Q4 06</b>	<b>Q1 07</b>	<b>Q2 07</b>	<b>Q3 07</b>	<b>Q4 07</b>	<b>Q1 08</b>	<b>Q2 08</b>	<b>Apr</b>	<b>May</b>	<b>Jun</b>	<b>Jul</b>	<b>Aug</b>
GDP growth (real)	% yoy	9.5	8.9	8.6	6.2	7.4	6.5	...	6.7	7.2	5.4	7.3	...
GDP growth (real)	% yoy cum.	7.1	8.0	7.9	7.3	7.6	6.5	...	6.2	6.4	6.3	6.5	...
Industrial production (real)	% yoy cum.	6.2	12.5	11.8	10.7	10.2	7.8	7.5	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	0.4	0.2	-0.3	10.9	...
CPI	% yoy eop	11.6	10.1	13	14.4	16.6	26.2	29.3	30.2	31.1	29.3	26.8	26.0
PPI	% yoy eop	14.4	17.9	20.6	19.6	23.3	31.8	43.7	37.5	39.4	43.7	46.3	46.9
Exports (USD)***	% yoy cum.	13.2	32.4	32.4	27.3	27.4	28.5	...	30.9"	35.8"	40.7"	...	...
Imports (USD)***	% yoy cum.	22.0	32.0	33.2	31.5	34.8	45.1	...	50.3"	52.3"	55.3"	...	...
Merchandise trade balance	USD bn cum.	-5.19	-1.74	-3.43	-6.12	-10.6	-4.3	...	-7.4"	-8.8"	-9.8"	...	...
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	33.3	34.4	35.5	37.9	38.1
Monetary Base	% yoy eop	17.5	27.7	38.4	50.6	46.0	41.4	38.9	45.6	38.8	38.9	41.6	40.2
Lending rate on UAH credits **	% pa, aop	15.1	14.0	13.9	13.7	14.0	14.6	17.2	16.9	17.5	17.3	17.1	17.3
Exchange rate (official)	USD aop	5.05	5.05	5.05	5.05	5.05	5.05	4.96	5.05	4.99	4.85	4.84	4.84
Exchange rate (official)	EUR aop	6.51	6.62	6.81	6.93	7.31	7.56	7.75	7.96	7.76	7.45	7.64	7.29

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

<b>Key Economic Indicators</b>		<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
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:

<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