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International financial crisis: echo in Ukraine

The current international financial crisis is centered on asset-backed securities. High default rates of US subprime mortgages triggered the abrupt downgrade of bonds linked to them, pushing stock indices down. Uncertainty over who bears the losses was one of the major problems. First, securitization resulted in high risk dispersion. Second, banks' investment vehicles, operating mostly with asset-backed instruments, were kept off-balance-sheet not allowing tracing the holders. As a result, banks became reluctant to lend even to each other. That generated liquidity problems and pushed interest rates in money markets up, despite the fact that all major central banks tried to calm the market by injecting liquidity and loosening the rules for extending credit.

The Ukrainian stock market index (PFTS) has also reacted to the crisis. In the middle of August it dropped by 10% (from 1088 points to 982), and returned to growth only in mid-September. However, low activity and smaller volumes of trade typical for holiday season could also exacerbate this market downturn.

Other impacts of the financial crisis on Ukraine's economy are also uncertain. There are several potential directions of impact: on private borrowings and thus investments, on state borrowings and thus budget, and on the stability of financing of the current account deficit.

In general, international borrowings are expected to become more expensive and difficult to attract. The banking sector could be hurt the most, as it is now the main external borrower in Ukraine. The external debt of the sector increased by 50.5% since the beginning of the year and in June reached USD 21.2 bn. Now its growth is likely to decelerate. In turn that could result in higher domestic credit rates and slower growth. But a lot will depend on how the international banks represented in Ukraine – most of them have their headquarters in the EU or the CIS – are affected by the crisis. So far, it is most evident in the US and UK.

The Ukrainian companies that planned direct borrowings abroad in the second half of the year may also be hurt. Most likely, they will have to attract money at higher interest rate. In the worst case, they will be forced to postpone borrowings. Also, the increase in interest rates will make servicing of loans with floating rates more expensive.

The disruption of private external borrowing could somewhat hamper investments, having a negative impact on economic growth. According to the Derzhkomstat, in the first half of 2007 more than 14% of investments in fixed capital were financed by bank loans and other borrowings. Now this source of funding could be truncated.

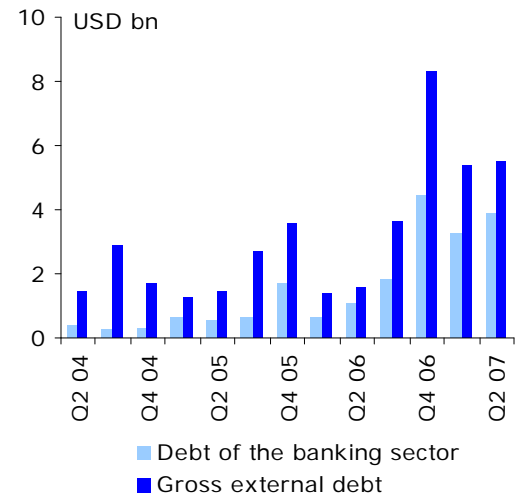
The effect of the financial market crunch on public finances is expected to be minor in the short-run. The prices of Ukrainian Eurobonds have remained stable. Moreover, other countries with the same rating managed to borrow successfully on the market after the crisis erupted.

The reduction of capital inflows could harm the stability of the current account deficit previously covered primarily by the strong inflow of medium- and long-term borrowing. But the effect could be quite the opposite if Ukraine's stock market is perceived as sufficiently disconnected with the American and European markets, and thus a good alternative for investments. This is now happening with emerging market securities, especially those of China and India, as these countries are considered as the drivers of global growth in the next few years.

In the short run consequences of financial crisis may be limited, as "crisis of confidence" would not last long. However higher sensitivity to risk and more selective approach to providing credit may have more lasting consequences and foreign lending may decline. This development is not necessarily negative as it can hamper excessive foreign borrowing but it can also hurt enterprises with sound investment needs.

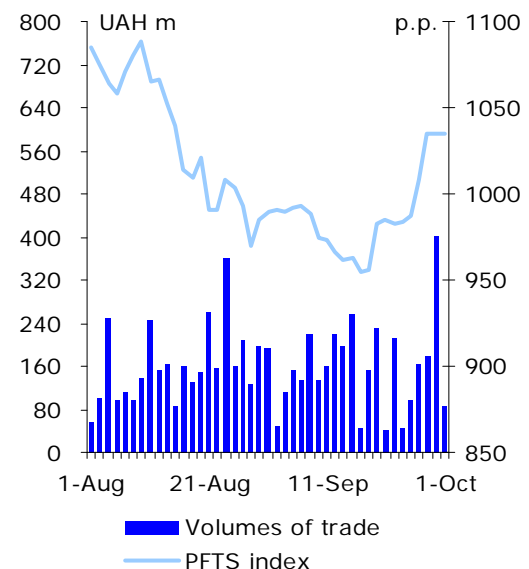
The development of the current situation will show the degree of integration of Ukraine to the world economy and its exposure to benefits and costs of such integration. To be able to sustain the shocks, the country has to mind its "fundamentals".

External debt of Ukraine



Source: NBU

Volumes of trade and PFTS index in 2007



Source: PFTS

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Quarterly trends

National accounts		Q2 04	Q3 04	Q4 04	Q1 05	Q2 05	Q3 05	Q4 05	Q1 06	Q2 06	Q3 06	Q4 06	Q1 07	Q2 07
GDP	UAH bn	78.6	99.4	100.1	84.3	97.5	119.4	123.6	105.4	124.1	150.4	157.7	133.1	161.4
GDP (real)	% yoy	12.7	14.3	9.1	4.9	3.4	1.4	1.7	4.1	6.8	6.9	9.5	8.0	7.9
Households consumption (real)	% yoy	18.0	9.7	12.5	14.3	17.7	17.0	17.1	20.2	18.2	11.8	9.9	14.7	15.5
State consumption (real)	% yoy	1.3	3.9	0.9	6.1	0.0	1.0	4.0	9.6	5.8	5.8	1.0	0.8	6.2
Gross fixed capital formation (real)	% yoy	22.6	23.8	16.8	-2.3	-0.5	0.2	0.3	19.9	19.3	17.9	18.3	24.4	23.5
Exports of goods and services (real)	% yoy	21.1	14.3	11.7	-0.6	-14.0	-12.7	-15.5	-14.9	-9.6	3.2	1.0	4.9	5.2
Imports of goods and services (real)	% yoy	10.9	7.2	8.7	2.8	3.2	3.9	-0.9	10.7	0.9	8.3	6.4	12.9	19.6
Agriculture, hunting, forestry (real)*	% yoy	0.2	35.6	11.3	5.8	8.3	2.6	-7.2	3.8	2.8	-5.6	8.1	4.8	6.8
Manufacturing industry (real)*	% yoy	15.0	9.9	6.9	7.0	1.8	-1.1	2.0	-1.5	6.1	7.3	7.2	15.0	13.2
Construction (real)*	% yoy	23.3	11.9	23.3	-8.4	-11.3	-8.5	-7.5	0.1	0.8	1.4	4.2	13.3	8.2
Trade, repair services (real)*	% yoy	17.4	13.9	2.5	-2.1	-10.7	-11.7	-11.9	6.2	16.4	20.0	21.9	14.3	17.5
Transport (real)*	% yoy	14.9	12.5	6.4	6.6	5.7	2.8	7.8	4.9	7.7	9.4	5.3	7.0	5.6
Balance of payments														
Current account balance	USD bn	2.3	2.1	1.1	1.6	0.6	0.4	-0.1	-0.8	0.0	0.5	-1.4	1.3	-0.7
Current account balance	% of GDP	15.8	11.0	5.7	10.1	3.2	1.7	-0.4	-3.7	0.0	1.7	-4.3	-5.0	-2.0
Trade balance in goods	USD m	1552	774	482	1020	-236	-1131	-788	-1353	-935	-884	-2022	-1753	-1430
Trade balance in services	USD m	198	749	157	188	392	1035	191	219	506	1054	347	50	403
Current transfers	USD m	758	720	623	626	694	745	780	622	790	851	910	789	923
Direct investment (FDI)	USD m	614	420	344	247	365	477	6474	1053	1389	1636	1258	1162	1772
Portfolio investments	USD m	149	1313	156	397	923	90	1347	4	-141	370	3350	1818	1519
Gross international reserves	USD bn	9.6	12.1	9.5	12.0	13.1	14.3	19.4	17.3	17.6	19.1	22.3	23.5	25.6
Exchange rate, UAH/USD	aop	5.33	5.31	5.31	5.30	5.10	5.05	5.05	5.05	5.05	5.05	5.05	5.05	5.05
Fiscal indicators														
Consolidated fiscal revenues	% of GDP	26.9	26.3	25.9	32.1	35.1	31.5	31.0	31.2	31.7	31.9	32.8	33.3	32.8
Personal income tax	% of GDP	4.1	3.8	3.8	4.3	4.4	3.9	4.2	4.4	4.6	4.1	4.1	5.1	5.3
Enterprise profits tax	% of GDP	4.0	4.1	6.1	4.8	5.9	5.3	6.3	3.4	4.6	4.3	6.7	3.8	4.1
Value-added tax	% of GDP	5.7	5.1	4.1	8.6	9.2	7.9	7.3	9.2	9.2	9.7	9.3	10.4	9.8
Excise tax	% of GDP	2.1	2.0	1.8	2.0	2.0	2.0	1.7	1.8	1.7	1.5	1.5	1.8	1.7
Consolidated fiscal expenditures	% of GDP	26.5	26.8	35.2	28.3	36.4	28.1	41.7	30.9	32.8	29.4	36.6	28.4	31.0
Current expenditures	% of GDP	22.7	21.7	27.2	26.5	33.6	24.0	34.2	28.9	29.7	24.9	29.2	26.9	28.4
Capital expenditures	% of GDP	3.8	5.1	8.0	1.8	2.7	4.1	7.5	1.9	3.2	4.5	7.4	1.6	2.6
Consolidated fiscal balance	% of GDP	0.4	-0.5	-9.3	3.7	1.0	-5.0	6.2	-0.4	1.1	-2.4	4.0	-4.8	1.7
Privatisation receipts	% of GDP	3.7	3.5	1.0	0.2	0.6	0.6	16.0	0.1	0.1	0.1	0.1	0.5	0.5
Labour market														
Average wage (real)	% yoy	18.6	14.7	15.4	15.0	19.0	19.6	26.4	23.8	22.6	18.8	11.3	11.5	12.0
Household income (real)	% yoy	16.3	11.3	16.6	24.0	28.0	19.4	18.9	22.1	18.6	20.3	16.3	11.1	10.8
Unemployment rate (ILO methodology)	% cum	8.3	8.1	8.7	8.7	7.1	5.2	7.8	7.9	6.8	6.4	6.8	7.4	6.6
Banking system														
Monetary aggregate M0	% yoy cum	25.6	37.1	27.9	28.2	39.1	31.1	42.2	36.2	25.3	23.7	24.5	22.9	30.4
Monetary aggregate M2	% yoy cum	44.8	51.5	32.3	38.9	37.4	31.3	53.9	39.2	36.6	36.7	34.3	38.6	40.7
Household deposits in national currency	% yoy cum	67.3	67.9	26.2	28.3	31.6	30.4	90.8	54.6	41.1	39.7	37.3	50.7	56.3
Household deposits in foreign currency	% yoy cum	61.7	55.2	54.3	51.8	45.4	46.4	59.1	54.5	66.2	64.3	57.5	52.3	43.8
Com. bank credits in national currency	% yoy cum	52.1	44.3	29.4	28.3	32.6	43.4	58.7	59.8	53.7	49.0	52.3	52.4	57.2
Com. bank credits in foreign currency	% yoy cum	56.2	43.5	32.2	33.1	36.8	47.1	66.3	72.0	82.1	90.4	95.4	98.9	97.4
Long-term com. bank credits	% yoy cum	102.7	82.7	57.1	49.5	53.0	70.1	84.6	87.6	86.7	76.6	79.5	84.1	86.5
Long-term com. bank credits	% of total	49.3	50.9	54.2	54.4	56.1	59.7	61.8	63.1	63.4	63.5	64.9	65.8	67.3
Average lending rate on national cur. credits	% p.a.	16.6	17.0	17.6	17.0	15.4	15.4	16.4	15.8	15.5	14.6	15.1	14.0	13.9
Average lending rate on foreign cur. credits	% p.a.	12.1	12.6	12.2	12.1	11.0	11.3	11.7	11.5	11.3	11.3	11.5	11.5	11.4

SOURCES: National Bank of Ukraine, State Committee of Statistics, State Treasury, Ministry of Finance, IER estimates

* change in value added