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UKRAINE Economic Update

July, 2008

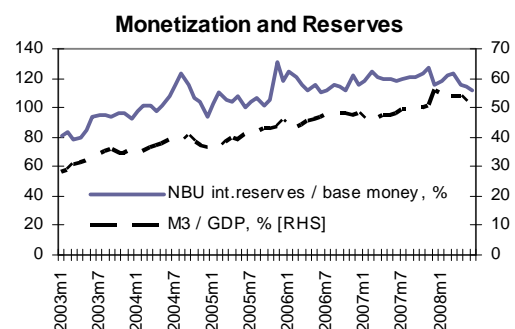
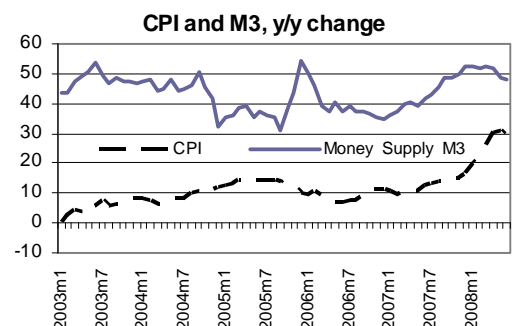
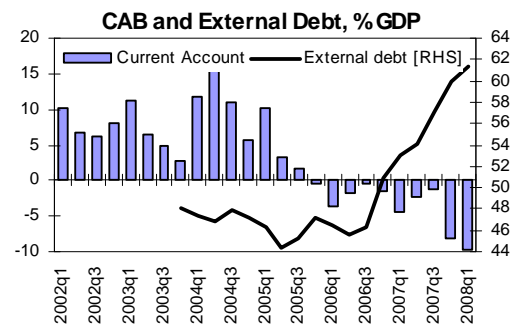
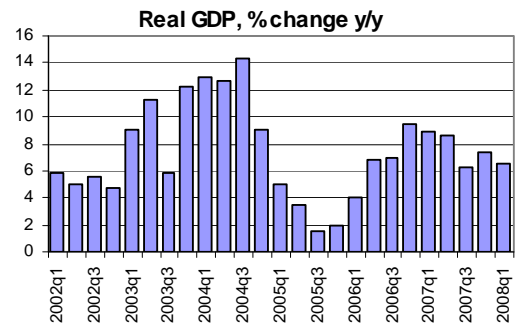
- **More of the same for 2008, as the demand-led expansion continues and external conditions remain unexpectedly favorable.**
- **Policy efforts to tighten fiscal and monetary policy to cool an overheating economy have been mired in political controversy and may yet suffer from electoral politics.**
- **We upped our growth and inflation forecasts for 2008 and still see a gradual adjustment as the base case for 2009, with higher downside risks.**

Recent Economic Developments

Domestic demand kept the economy expanding at above 6% in 1H 2008, as external conditions remained favorable. In Q1, real GDP grew by 6.5%, with 15% and 22% y/y growth in fixed investment and private consumption, respectively while import growth (20%) continued to vastly outstrip export expansion (1%). Higher steel and chemicals prices boosted the terms of trade by another 10% containing the widening of external imbalances. The current account (CA) in Q1 nonetheless reached -9.8% of period GDP in line with our earlier forecast. Two thirds of the CA deficit were financed by FDI and debt inflows continued despite widening spreads for Ukraine (by 180bps since Dec07) in international markets, allowing the NBU to accumulate USD 3bn in H1.

Inflation soared, confirming earlier warnings that the economy was overheating. Consumer inflation reached a peak in May with 31.1% y/y, before marginally retreating to 29.3% in June. Soaring food prices of 50% were the main contributor. Meanwhile, PPI growth further accelerated to 43.7% y/y on the back of commodity price developments. The iron and steel, mining iron ore, and oil products price indices were up (y/y) 68%, 95%, and 75%, respectively.

Macroeconomic policies tightened in response, but were mired in political controversy. In Jan-May, nominal budget revenues were up 46% y/y thanks to higher than planned inflation and some improved collection, while spending was kept within the plan leaving the consolidated budget in surplus (at 3.4% of period GDP). Planned budget amendments to spend the extra revenues would largely undo this effort. Following weeks of interbank market fluctuations outside of the de-facto band of UAH/USD 5–5.06, the NBU on May 22 revalued the official exchange rate from UAH/USD 5.05 to 4.85. Subsequently, the NBU council set a new exchange rate band for H2 2008 at UAH/USD 4.85 +/- 4%. The move seems to indicate a gradual shift to greater exchange rate flexibility. A period of tighter liquidity and higher interest rates caused credit growth to slow down moderately to 64% y/y in June, the lowest growth since Dec 05.



Medium Term Outlook

We have revised up our 2008 growth and inflation forecast based on the current external price environment. Ukraine is a net beneficiary of the recent developments in the global economy. The commodity price boom has led to terms of trade gains of close to 40% since 2003, underwriting the growth momentum despite the tightening of global financial conditions. The expected grain harvest at well over 40 million tons will compensate for weakening trends in industry and construction in 2H 2008 and we now expect growth at 6% for the year. Our inflation forecast is also up, since even with food prices ebbing down as the good harvest is brought to market, macro-policies remain insufficiently tight for a faster pace of disinflation, and electoral pressures may prevent a further tightening during 2008.

We see 2009 as a year of gradual adjustment, with growth slowing to 4.5% and inflation moving back into the middle teens. The fall by 6.4% in the terms of trade, as metal prices stabilize and gas import prices adjust further towards European levels is a key underlying assumption. This together with the impact of slowing credit growth should help contain domestic demand to a more sustainable pace. Even under this gradual adjustment scenario, the CA deficit moves above 11% of GDP, requiring external financing of some USD 25bn. We expect gradually stabilizing international markets and Ukraine's strong underlying value proposition to ensure this continues to be met through FDI and private lending. We see domestic utility tariffs adjusting to reflect rising import costs, thus keeping the headline CPI above 15% eop, but with core inflation trending down faster.

A fiscally prudent budget and tight monetary policy are core ingredients for the gradual adjustment to take hold. Absent a further widening of the exchange rate band, the NBU will need to rely on tightening prudential regulations to further slow the pace of credit growth and curb short-term capital inflows, whilst monitoring liquidity in the banking sector. But the burden of adjustment will remain on fiscal policy, which should target real income increases in the 2009 budget in line with underlying productivity growth, implying a modest increase in nominal wages and social transfers. This would help stabilize inflationary expectations and contain the further deterioration of the CA. In Ukraine's unstable political environment, the downside risks to this scenario are considerable. While commodity prices might continue to surprise on the upside thereby reducing the need for domestic tightening to some extent, we think risks are biased in the opposite direction. An acceleration of structural reforms to boost domestic supply would contain the dip and lead to faster growth beyond 2009.

Table 1: Key Macroeconomic Indicators

	2003	2004	2005	2006	2007	2008F	2009F	2010F
Nominal GDP, UAH billion	267.3	345.1	441.5	544.1	712.9	973.1	1170.4	1369.0
Real GDP, % change	9.6	12.1	2.7	7.3	7.6	6.0	4.5	5.0
Consumption, % change	10	9.7	15.7	12.4	13.4	10.4	4.6	5.0
Fixed Investment, % change	22.5	20.5	3.9	21.2	24.8	11.8	4.2	3.8
Export, % change	10.3	21.3	-12.2	-5.6	3.2	4.3	5.3	5.5
Import, % change	16.4	15.5	6.4	6.8	19.9	14.8	5.0	4.8
GDP deflator, % change	8	15.2	24.6	14.8	21.7	28.8	15.1	11.4
CPI, % change eop	8.2	12.3	10.3	11.6	16.6	21.5	15.3	9.8
Current Account Balance, % GDP	5.8	10.6	2.9	-1.5	-4.2	-8.4	-11.3	-11.1
Terms of Trade, % change	1.7	3.5	8.3	4.9	9.8	6.0	-6.4	-1.3
Budget revenues, % GDP	38.0	37.1	41.8	43.7	42.3	42.9	42.0	41.3
Budget expenditures, % GDP	38.9	41.5	44.1	45.1	43.8	44.4	44.0	43.0
Fiscal balance, % GDP	-0.9	-4.4	-2.3	-1.3	-1.5	-1.5	-2.0	-1.6
External debt, % GDP	47.5	47.1	45.3	50.4	59.9	55.8	55.5	54.5
Public and Guaranteed Debt, % GDP	29.0	24.7	17.7	14.8	12.4	10.4	10.7	10.9

Source: Ukrainian Authorities, WB projections