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UKRAINE Economic Update

July, 2007

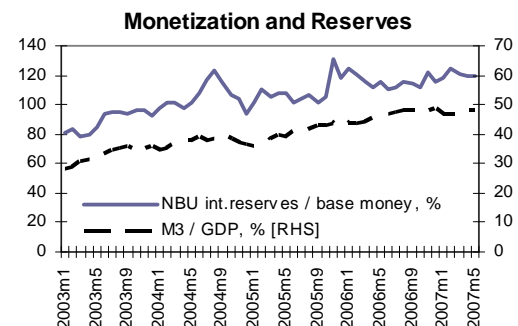
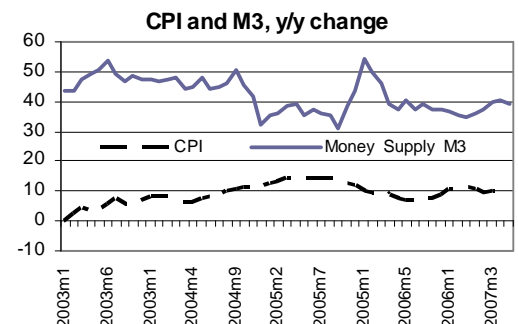
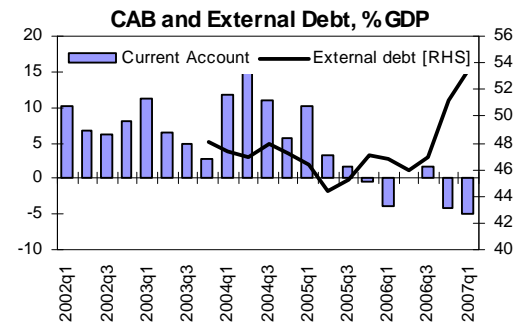
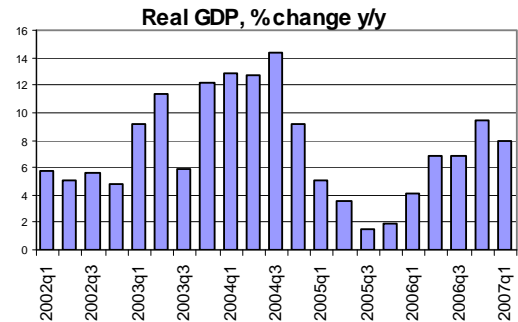
- **Ukraine continues to benefit from a benign external environment, while the domestic political crisis has had limited impact on market sentiment.**
- **The rapid expansion of the financial sector is both a boon to Ukraine and a key risk factor going forward.**
- **To be better insulated against potential external shocks and sustain high growth over the medium term, Ukraine should take a number of measures in macroeconomic policy, financial market regulation and structural reform.**

Recent Economic Developments

The political crisis has had limited impact on the economy and the markets. Output performance, though decelerating, remains strong. In Jan-May 2007, real GDP posted a 7.9% y/y growth with retail trade, construction and manufacturing in double digits. Industrial production grew 12.1% y/y boosted by machine building and iron and steel. Investment demand is running high, a factor emphasized by the 2006 revisions to the national accounts. CPI inflation remains around 10% y/y, while the PPI hit the 20% y/y mark in May, led by favorable price developments in the export oriented metals industry.

A key factor underlying economic buoyancy has been the growing inflow of foreign capital. This has supported strong credit growth and allowed the growing current account deficit to be easily financed. Import growth of 35% y/y in Jan-Apr drove the trade deficit up to US\$ 3 billion, despite strong export performance. Higher gas prices were offset by strong prices for iron and steel to leave Ukraine's terms of trade relatively unchanged. The current account deficit of 5% GDP (USD 1.3 b) in Q1 was almost fully covered by FDI inflows of USD 1.1 billion. Gross external debt increased by USD 5.6 billion in 1Q and reached USD 60 billion (54% GDP), driven by long-term bank borrowing which grew by USD 3.1 billion. NBU's forex reserves reached USD 24.8 billion in May following record purchases of US\$1.4 billion that month. Ukraine's stock market index PFTS posted a new high in June, 25% up since the start of the political crisis and 110% YTD, making it one of the top performers in the world in 2007.

Recent budget amendments will not jeopardize the overall fiscal deficit target.. In Jan-Apr the consolidated budget was in surplus of 1% of annual GDP as revenues over-performed. The Parliament reconfirmed and the president signed the budget 2007 expenditure increases in the amount of UAH 5b (0.8% GDP) to be financed by extra revenues from better than earlier projected nominal GDP. In June, Ukraine placed USD500 million in five-year bonds at 6.385% (130 bp over US treasury bonds).



Medium Term Outlook

We have marginally revised upward our 2007 growth forecast, based on a more benign external price and financing environment. In particular, rapid financial sector expansion, helped by foreign investors' 're-discovery' of Ukraine has become a major driver of economic performance. Our base case continues to assume a gradual deceleration in the growth of domestic demand, a moderate worsening of Ukraine's external terms of trade and continued good access to external financing. Moreover, we assume only partial pass-through of energy prices to consumers, and have reduced our CPI inflation forecast for 2007 but increased marginally the CPI forecasts in the outer years. We have not revised our medium-term growth forecasts, however, in the absence of greater structural reform progress.

While growing access to external financing has been a boon to Ukraine, the rapid expansion of the financial sector is also a source of risk going forward. Ukraine's financing constraint has been significantly relaxed over the past three years. Gross external debt is now 2.5 times higher than 3 years ago, while banking sector external liabilities are 10 times higher. There are clear signs that this is now translating into investment, thereby relaxing future constraints to growth. At the same time, rapid credit expansion, including forex lending to unhedged households, may hide underlying problems, due to an incomplete regulatory and supervisory framework and weaknesses in risk management among second tier banks. A negative external shock, such as the combination of higher world interest rates and subsequent declines in commodity prices could hit Ukraine's financial sector and the country's growth prospects.

Ukraine can not influence commodity prices or world liquidity, but it should be better prepared to face potential shocks. For macroeconomic policy this means (i) not to fuel the boom in aggregate demand further through promises of high wage and pension increases; and (ii) to use the relative monetary independence provided by the lack of full capital account convertibility to tighten domestic liquidity through rising reserve requirements, and by letting the exchange rate move up within a somewhat larger band. For financial market regulators now is a good opportunity to strengthen their capacity and lay the legal foundations for a move towards risk based and consolidated supervision, as NBU is already doing. Last but not least, the Government should strive to make Ukraine an attractive place for investments even in times of global investor pessimism. The political crisis has implied delay to key policy initiatives ranging from judicial reform, the adoption of a new tax code and a new company law to key reforms in public sector finance and administration. The support of legislation to ensure WTO accession can proceed in 2007 has revealed a consensus on the broad direction of economic policy in Ukraine. Ukraine should move rapidly following the parliamentary elections to capitalize on this consensus.

Table 1: Key Macroeconomic Indicators

	2002	2003	2004	2005	2006	2007F	2008F	2009F
Nominal GDP, UAH billion	225.8	267.3	345.1	441.5	537.7	643.5	741.3	837.6
Real GDP, % change	5.2	9.6	12.1	2.7	7.1	6.0	5.5	5.0
Consumption, % change	5	10	9.7	15.7	11.9	7.2	5.2	4.4
Fixed Investment, % change	3.4	22.5	20.5	3.9	18.7	11.1	10.2	6.1
Export, % change	7.4	10.3	21.3	-12.2	-4.9	5.2	5.4	5.2
Import, % change	3.3	16.4	15.5	6.4	6.5	9.0	7.1	4.8
GDP deflator, % change	5.1	8	15.2	24.6	13.7	12.9	9.2	7.6
CPI, % change eop	-0.6	8.2	12.3	10.3	11.6	9.7	9.6	8.3
Current Account Balance, % GDP	7.5	5.8	10.6	2.9	-1.5	-3.9	-5.3	-5.9
Terms of Trade, % change	1.4	1.7	3.5	8.3	3.8	0.1	-1.2	-1.0
Budget revenues, % GDP	35.7	35.9	35	39.7	41.7	41.3	40.7	39.5
Budget expenditures, % GDP	35.5	36.8	39.5	42	43.0	44.1	43.3	42.5
Fiscal balance, % GDP	0.2	-0.9	-4.5	-2.3	-1.3	-2.8	-2.6	-3.0
External debt, % GDP		47.5	47.1	45.3	51.0	55.2	59.1	62.0
Public and Guaranteed Debt, % GDP	36.5	29.0	24.7	17.7	15.0	14.5	15.1	16.6

Source: Ukrainian Authorities, WB projections