



THE WORLD BANK

UKRAINE Economic Update

October, 2007

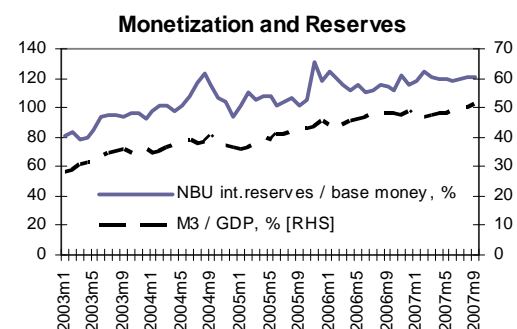
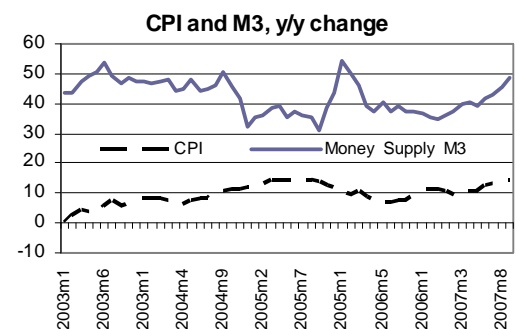
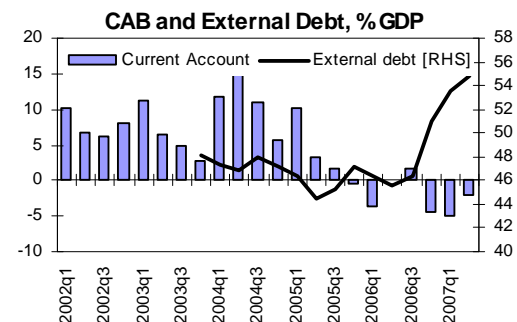
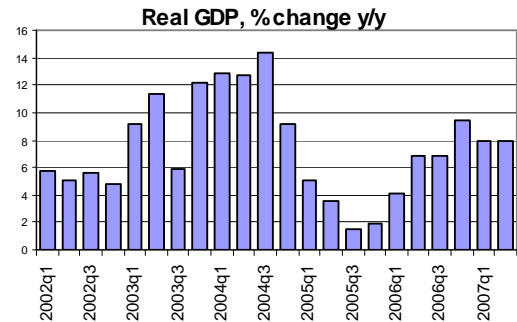
- **Economic growth remains strong despite political volatility and global market jitters, with high steel prices a key supporting factor.**
- **Financial sector liquidity has remained high through the recent market turmoil indicating resilience, but underlying credit risk may be masked by the pace of credit expansion.**
- **The balance of risks is moving towards the downside, with rising external deficits and growing inflationary pressures the key concerns.**

Recent Economic Developments

Growth once more outperforms expectations. In Jan-Sep 2007, real GDP grew by 7.5% y/y on the back of solid growth of retail trade, construction and manufacturing. Industrial production grew 10.7% y/y boosted by accelerated machine building and decent outturns in iron and steel and food-processing industries. National accounts data for 2007H1 point to strong investment demand (+19.6% y/y) and private consumption (+15.1% y/y) as key growth drivers. The contribution of external demand was negative, as the real growth in imports (+16.4%) outstripped export expansion (+5% y/y). However, the CA deficit remained modest at 3.3% GDP (USD 2 b) in H1 as a sharp rise in steel prices boosted Ukraine's terms of trade.

Early parliamentary election and global financial jitters have hardly shaken domestic financial markets. Triggered by concerns over the fall-out from the sub-prime mortgage crisis in the US, liquidity tightened in international markets in July, leading to higher risk premia including for Ukraine, which had however partially reversed by October. Forex reserve accumulation by the NBU continued and liquidity in the banking system remained high. During Q3 NBU forex reserves grew by USD 4.7 billion to USD 30.6 billion. Equity markets declined somewhat during the summer but had recovered to new historical highs by October. Gross external debt increased by USD 5.5 billion during Q2 (53% y/y) and reached USD 65 billion (55% GDP). The upward trend continues to be dominated by the banking sector.

Inflationary pressure has become a major macroeconomic concern. All major inflation indicators are currently in double digits. In Sep, CPI inflation increased to 14.4% y/y, PPI inflation remains high at around 20% y/y, the GDP deflator was 18.8% y/y in H1 and is preliminary estimated at 20.8% in Jan-Sep. High inflation is explained by a combination of increased prices for Ukraine's main export commodities, a recent global trend of rising food prices, the effect of rising energy prices, high money growth triggered by capital inflows and continuous rapid growth of households incomes.



Medium Term Outlook

We have revised upward our 2007 growth and inflation forecasts, while the budget deficit has been revised downward. The GDP growth revision is based on a significantly better external price and financing environment. National accounts data for 2007H1 showed that export prices were up by 23% and the terms of trade have improved by 8%. However, we expect the terms of trade gains to decelerate in H2 to an annual 6%, and growth to settle at 6.7%. Inflationary pressures have gathered force, although base year effects will allow the eop CPI to slow to 12.5% by year end, as the large energy price adjustments in 2006Q4 drop out. Higher than forecast nominal GDP is likely to reduce the budget deficit to below 2% GDP.

Our base case forecast continues to assume a gradual deceleration in the growth of domestic demand, a moderate worsening of Ukraine's external terms of trade and continued access to external financing. The impact of politics on the economic situation is likely to remain muted, although structural reforms are likely to advance only gradually. The government is projected to maintain fiscal prudence keeping the budget deficit below 3 percent. The rebalancing of risks, currently underway in the international financial markets, is likely to imply a deceleration of foreign capital inflows that will lead to a more moderate rate of domestic credit growth. After bigger 2007 terms of trade gains, we now factor in a somewhat steeper decline over the medium term. Correspondingly, the revised CA forecast is projected to exceed the 6% GDP mark already next year.

External factors remain the key downside risk to Ukraine's medium-term outlook. Ukraine's terms of trade have now improved for six consecutive years since 2002 and by a cumulative 25%. This positive boost cannot last forever. To illustrate the risk of a downturn, we calculated what would have happened in 2007 had the terms of trade remained flat. Our model suggests that the CA deficit would have increased by USD 2.4 billion to 7.5% GDP. By the same token, assuming the terms of trade in 2008 were to deteriorate by 7.2% rather than the forecast 3.6%, the CA deficit would grow by 1.6pp. to 7.8% GDP. Should the size of the external imbalances lead to greater investor caution and reduced capital inflows, the necessary correction of domestic demand to bring the CA deficit back below 7% GDP would imply a reduction in economic growth by perhaps 1 pp. of GDP to 4.5%. Lower growth and reduced liquidity could also affect the banking sector, with potentially negative knock-on effects. On the positive side, these risks are balanced by the possibility of further dollar weakness, which would help Ukraine maintain competitiveness and contain the rise in external deficits.

Table 1: Key Macroeconomic Indicators

	2003	2004	2005	2006	2007F	2008F	2009F	2010F
Nominal GDP, UAH billion	267.3	345.1	441.5	537.7	685.6	814.4	927.0	1044.4
Real GDP, % change	9.6	12.1	2.7	7.1	6.7	5.5	5.0	5.0
Consumption, % change	10	9.7	15.7	11.9	9.8	5.4	4.5	4.7
Fixed Investment, % change	22.5	20.5	3.9	18.7	14.8	8.2	7.2	5.1
Export, % change	10.3	21.3	-12.2	-4.9	4.8	6.1	6.3	6.5
Import, % change	16.4	15.5	6.4	6.5	13.4	6.7	6.5	5.9
GDP deflator, % change	8	15.2	24.6	13.7	19.5	12.6	8.4	7.3
CPI, % change eop	8.2	12.3	10.3	11.6	12.5	9.6	8.3	7.4
Current Account Balance, % GDP	5.8	10.6	2.9	-1.5	-3.5	-6.2	-7.3	-7.7
Terms of Trade, % change	1.7	3.5	8.3	3.8	5.9	-3.6	-2.0	-1.3
Budget revenues, % GDP	35.9	35	39.7	41.7	41.0	40.5	39.9	39.2
Budget expenditures, % GDP	36.8	39.5	42	43.0	42.8	42.8	42.3	41.5
Fiscal balance, % GDP	-0.9	-4.5	-2.3	-1.3	-1.8	-2.2	-2.5	-2.4
External debt, % GDP	47.5	47.1	45.3	51.0	54.4	54.9	54.8	54.3
Public and Guaranteed Debt, % GDP	29.0	24.7	17.7	15.0	14.5	15.1	15.9	16.3

Source: Ukrainian Authorities, WB projections