THE WORLD BANK

UKRAINE Economic Update

January, 2008

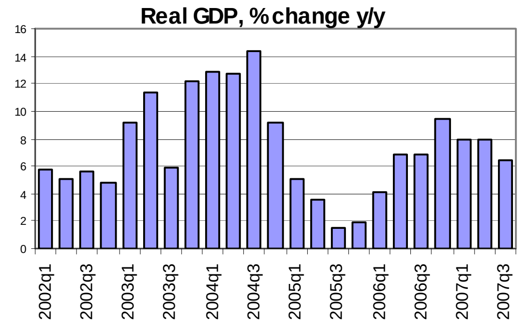
- ***Ukrainian growth in 2007 again outperforms, on the back of record financial inflows, buoyant domestic demand and once again high terms of trade gains.***
- ***With money growing fast and budget spending revised upwards, inflation has become uncomfortably high.***
- ***As global turbulence continues, the balance of risks remains on the downside and the room for policy maneuver is shrinking.***

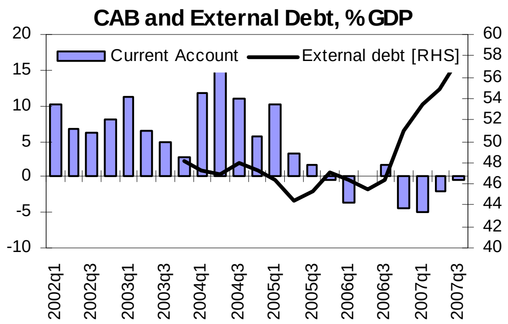
Recent Economic Developments

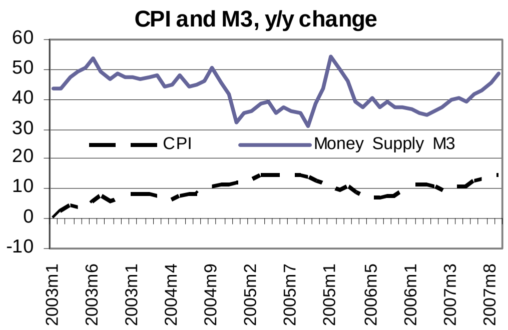
2007 was another year of strong growth in line with regional trends. Real GDP is preliminarily estimated to have grown 7.3% y/y due to solid growth of retail trade, construction and manufacturing, while agriculture declined following a poor harvest. Industrial production growth decelerated in Q4 to 10.2% y/y in 2007, with metals flat y/y in Dec and slowing to 8.3% for the year. National accounts data for 2007Q3 point to the continuing boom of domestic demand, while net external demand remains negative. In Jan-Sep, fixed investment grew 21.8% y/y, private consumption increased 15.2% y/y, which in turn fuelled 15.4% real growth in imports, whereas real exports expanded by 3.1% y/y. However, further increases in the prices for Ukrainian exports allowed the current account deficit to remain modest at 2.2% GDP. The estimated terms of trade gain for Ukraine over Jan-Sep was 8.3%, much above our earlier forecasts.

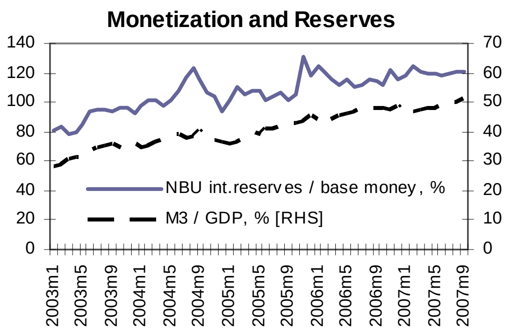
Ukraine attracted record capital flows in 2007. NBU reserve accumulation totaled USD 10.2bn with reserves ending at USD 32.5bn. Ukraine's stock market growth was second in the world after China with an increase of 135%. Gross external debt increased by USD 9 billion during Q3 (61% y/y) and reached USD 74 billion. Net FDI inflows were USD 7.1 billion in Jan-Sep. The resulting expansion of the money supply M3 reached 52% y/y in Dec.

As all key inflation indicators have moved into double digits, the economy is at risk of overheating. There is clear evidence that domestic price pressures are building. In Q3, the consumption deflator stood at 17.2% y/y and the investment deflator rose 18.3% y/y. Year-end construction prices were up 22% and overall producer prices 23.2%. The eop CPI inflation at 16.6% was the highest since 2000. Given the large share of food in the CPI, around half of its increase can be attributed to four product categories - milk, cooking oil, fruits and vegetables – in line with the global trend of the growing food prices. However, the persistent rapid growth of nominal households' incomes and the ongoing credit boom, have driven the non-food, goods CPI to 6% from just 2.6% in 2006. Survey evidence also indicates that inflationary expectations are rising.









Medium Term Outlook

We have not changed our 2008 growth forecast but have revised upward the inflation forecast. Real GDP growth will slow to 5.5% on the back of a moderation in both consumption and investment growth. We believe the authorities understand the need for some fiscal tightening to mitigate external risks - opportunities to do this include household energy tariff adjustments and improved tax collection. We also assume corporate profit growth will slow down due to a modest decline in the terms of trade; as a result, the corporate sector is likely to push for lower wage settlements. At the same time, access to credit will become more expensive due to rising spreads and tightened prudential regulations thus slowing corporate investment growth. We have increased the CPI forecast to 13.8% eop reflecting rising inflation expectations and a fairly expansionary 2008 budget. According to the 2008 state Budget law, consolidated budget expenditures are projected to grow by 34% y/y in nominal terms, with much of the increase concentrated on consumption spending and social transfers.

Our forecast and underlying assumptions imply a significant widening of external imbalances. The current account deficit is forecast to reach 7.8% of GDP in 2008 and 9.2% in 2009, falling back moderately thereafter. Underlying these developments are continued buoyant domestic demand and the assumption of a turnaround in the terms of trade. We assume that metal prices are sustained at their historically high 2007 levels, but forecast in the 38% increase in gas import prices. We also assume an uptake in real export growth, following recent investments and continued strong demand from Russia. The deficit should be easily financed by FDI (up to USD 9 billion in 2008) and continued debt and portfolio inflows. However, we believe net debt inflows will moderate, reserve accumulation will be small, and as a result domestic money and credit growth will decelerate.

Downside risks to our forecast have increased further. International financial markets experienced significant additional turbulence in January 2008 and concerns over the impact of a US slowdown on global growth prospects have risen. This could create downside risks to our terms of trade and export growth forecast. Moreover, while Ukraine's financial markets seem to have remained relatively sheltered in recent months, a flight to safety and tightening liquidity could affect access to financing for Ukrainian banks and corporates without strong parent support. The international environment and domestic inflationary pressure have significantly reduced the room for policy maneuvre and will place a premium on coherent policy making to contain domestic demand and advance reform to improve Ukraine's competitiveness.

Table 1: Key Macroeconomic Indicators

	2003	2004	2005	2006	2007E	2008F	2009F	2010F
Nominal GDP, *UAH billion*	267.3	345.1	441.5	544.1	708.8	873.4	1011.5	1150.0
Real GDP, *% change*	9.6	12.1	2.7	7.3	7.3	5.5	5.0	4.5
Consumption, *% change*	10	9.7	15.7	12.4	11.6	7.7	6.1	2.5
Fixed Investment, *% change*	22.5	20.5	3.9	21.2	18.1	8.1	6.4	4.7
Export, *% change*	10.3	21.3	-12.2	-5.6	3.3	5.4	5.5	6.3
Import, *% change*	16.4	15.5	6.4	6.8	15.2	9.6	7.7	3.0
GDP deflator, *% change*	8	15.2	24.6	14.8	21.4	16.8	10.3	8.8
CPI, *% change eop*	8.2	12.3	10.3	11.6	16.6	13.8	10.8	9.6
Current Account Balance, *% GDP*	5.8	10.6	2.9	-1.5	-3.2	-7.8	-9.2	-8.8
Terms of Trade, *% change*	1.7	3.5	8.3	4.9	8.1	-2.8	-1.6	-1.2
Budget revenues, *% GDP*	35.9	35	39.7	41.0	40.1	40.2	39.4	38.9
Budget expenditures, *% GDP*	36.8	39.5	42	42.3	41.4	42.1	42.1	41.0
Fiscal balance, *% GDP*	-0.9	-4.5	-2.3	-1.3	-1.3	-2.0	-2.7	-2.1
External debt, *% GDP*	47.5	47.1	45.3	50.4	53.0	48.8	47.7	51.0
Public and Guaranteed Debt, *% GDP*	29.0	24.7	17.7	14.8	12.7	11.9	13.2	14.0

Source: Ukrainian Authorities, WB projections

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