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UKRAINE Economic Update

April, 2008

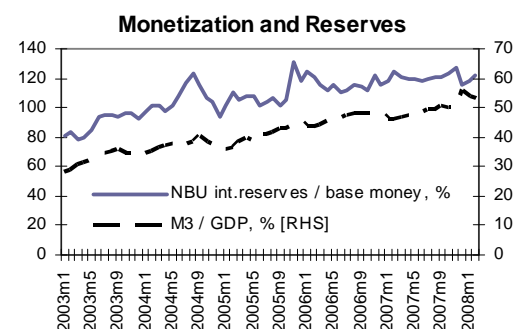
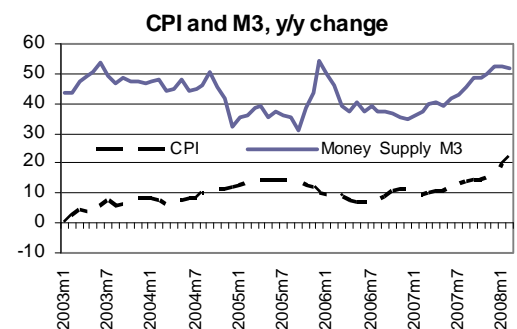
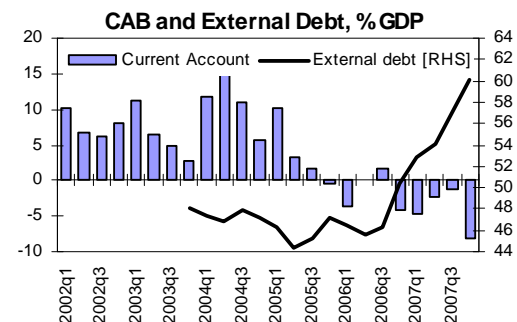
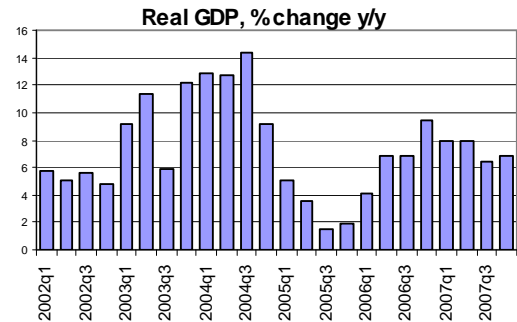
- **Booming commodities support growth but also add to domestic inflationary pressures, as Ukraine continues to weather the global turmoil.**
- **Political spending pressures reduce the scope for disinflation in 2008, even if monetary conditions tighten somewhat.**
- **We still forecast a smooth adjustment with a gradual rebalancing between domestic and external demand, but see significant downside risks to this scenario.**

Recent Economic Developments

Strong domestic demand continues to drive Ukraine's economy, supported by high export prices and financial inflows. According to 2007 national account data, domestic demand contributed 16 p.p. to the 7.3 % GDP growth. With booming domestic demand, imports surged by 19.7% in real terms while real exports grew by only 3.1%. However, buoyant export prices (including steel, chemicals, food products) resulted in another terms of trade gain of 10% over 2007, keeping the current account deficit to a regionally moderate 4.2% GDP.

Global market turbulence has so far failed to curb the appetite of Ukraine's private sector for foreign capital inflows. External debt increased by USD 30 billion in 2007 (or by 55%) bringing the stock to 60% of GDP. Net FDI amounted to USD 9.2 billion (6.6% GDP), and portfolio investment inflows were at a record high of USD 5.8 billion (4.1% GDP). With the NBU effectively keeping the UAH exchange rate within a narrow band to the USD, capital inflows drove money growth to over 50% y/y. While monetary conditions have tightened recently, access to the international bond and syndicated loan market has reduced for Ukrainian banks and corporates, and the stock market lost about 20% since its peak in January, private sector credit growth has continued unabated at over 70% y/y. Support from parents has allowed foreign owned banks in particular to grow their market share, despite attempts by the NBU to cool the credit market with broader provisioning requirements.

Inflationary pressures have further increased as a result of the global trend of growing food prices and booming domestic demand. The CPI reached 26.2% y/y as of March, fuelled by a 40.7% y/y increase in food prices. Global factors have contributed to rising prices but macroeconomic policy has done little to reduce inflationary pressures to date. Nominal wage growth accelerated to over 40% y/y in Feb, while the current expenditure of the consolidated budget grew by 67% y/y in Jan-Feb. The government has developed an anti-inflation plan coordinated with the NBU which calls for tighter fiscal policy. The government has also intervened to limit food exports, a move likely to be ineffective in reducing inflation whilst curbing much needed export revenues.



Medium Term Outlook

With steel prices up more than 20% in 1Q 2008, Ukraine's external luck seems to run on. Despite a 38% gas price increase, Ukraine's terms of trade may thus continue to improve somewhat this year. We keep our growth forecast at 5.5%, driven by continued strong domestic demand. Despite tightening financing conditions on international markets, rising FDI, and parent support to the largest commercial banks are expected to comfortably finance the 8.7% current account imbalance. At the same time, we have further increased our inflation forecast to 17.2% end-year in reflection of rising international commodity prices and CPI results for the first three months of 2008, and do not expect fiscal tightening to be sufficient to reduce inflation this year.

The flipside of a robust growth and external financing outlook for 2008 is that Ukraine will enter 2009 in a distinctly unbalanced position. The current commodity price boom is at least partially driven by portfolio allocations in the face of a declining US dollar and risks for metal prices beyond 2008 are clearly on the downside. At the same time, Ukraine faces the likelihood of increased gas import prices in the wake of Russia's agreement with the Central Asian states to pay prices at European levels minus transportation costs from 2009. We thus forecast a decline in Ukraine's terms of trade by 5%, which will initiate a process of adjustment reflected in lower absorption and GDP growth and more significant declines in inflation. Our base case scenario foresees fiscal policy to support the adjustment to some extent through a more conservative nominal spending envelope in the 2009 budget, and through energy and communal tariff increases starting in 2008 to avoid a widening of quasi-fiscal imbalances. Monetary conditions will continue to tighten globally which should eventually feed into moderating credit growth and reduced investment demand.

The smooth adjustment scenario faces significant downside risks, from policy as well as external developments. In the face of presidential elections in 2009, the consensus needed to pass a prudent 2009 budget and embark on the necessary structural reforms (including of energy pricing) to support the necessary adjustment will be challenging to obtain. Further fiscal expansion and associated demand pressures could lead to excessive external imbalances and a sudden stop in access to financing. Larger terms of trade declines or a flight of capital from emerging markets also present significant downside risks.

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	709.4	914.5	1082.2	1253.0
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	14.0	8.5	5.6	4.1
Fixed Investment, % change	22.5	20.5	3.9	21.2	21.9	7.7	4.4	3.9
Export, % change	10.3	21.3	-12.2	-5.6	3.1	4.7	4.9	5.6
Import, % change	16.4	15.5	6.4	6.8	19.7	10.9	5.6	4.5
GDP deflator, % change	8	15.2	24.6	14.8	21.5	22.2	12.7	10.8
CPI, % change eop	8.2	12.3	10.3	11.6	16.6	17.2	13.0	9.9
Current Account Balance, % GDP	5.8	10.6	2.9	-1.5	-4.2	-8.7	-11.3	-11.3
Terms of Trade, % change	1.7	3.5	8.3	4.9	9.9	0.9	-5.1	-1.2
Budget revenues, % GDP	38.0	37.1	41.8	43.7	42.3	42.7	42.0	41.1
Budget expenditures, % GDP	38.9	41.5	44.1	45.1	43.8	44.6	44.6	43.4
Fiscal balance, % GDP	-0.9	-4.4	-2.3	-1.3	-1.5	-2.0	-2.6	-2.2
External debt, % GDP	47.5	47.1	45.3	50.4	60.2	55.1	55.8	56.5
Public and Guaranteed Debt, % GDP	29.0	24.7	17.7	14.8	12.2	11.2	12.1	12.7

Source: Ukrainian Authorities, WB projections