

CASE Ukraine

Center for Social and Economic Research



3

UKRAINIAN ECONOMIC OUTLOOK

tendencies

estimates

forecasts

CON

CONTENT

1. Overview of Economy in 2Q07	3
2. GDP and Value-Added	5
3. Energy Sector	7
4. Household Revenues	9
5. Prices	11
6. Forex Market	13
7. Monetary Policy	14
8. Financial Markets	16
9. Budget and Fiscal Policy	18
10. Foreign Trade	21
11. Balance of Payments	22
12. Foreign Direct Investment	23
13. Assumptions	25

Statistical Appendix	26
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<i>Table 1.</i> Value Added in Major Sectors of the Economy	27
<i>Table 2.</i> Components of Aggregate Demand	28
<i>Table 3.</i> Real Sector	29
<i>Table 4.</i> Selected Indicators for Enterprises	30
<i>Table 5.</i> Household Revenues	31
<i>Table 6.</i> Prices	32
<i>Table 7.</i> Labor Market	33
<i>Table 8.</i> Exchange Rates	34
<i>Table 9.</i> Balance of Payments	35
<i>Table 10.</i> External Merchandise Trade: Geography Structure	36
<i>Table 11.</i> External Merchandise Trade: Commodity Structure	37
<i>Table 12.</i> Budget	38
<i>Table 13.</i> Interest Rates	39
<i>Table 14.</i> Money Aggregates	40
<i>Table 15.</i> Credits and Deposits	41

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HIGHLIGHTS

Private consumption underpins GDP growth	3
Machinery benefits from high external demand	3
Energy intensity of economy reduced slightly	7
Gas import prices are expected to increase moderately in 2008	7
Real income growth decelerates	9
Wages in metallurgy grew by 35.5% in nominal terms	9
Consumer prices grew by 4.2% in 1H07	11
Poor grain harvest poses new risks of CPI growth	11
Foreign currency surplus prevailed throughout 1H07	13
REER of UAH revalued by 2.3% in 1H07	13
Rebound of monetary base growth	14
Acceleration of credits and deposits	14
SFTS index broke 1000 points ceiling	16
Budget revenue plan revised upwards	18
Privatization plan is close to failure	18
Export growth decelerated in 2Q07	21
Exports of machinery grew the fastest	21
Services trade performance deteriorated	21
Current account deficit exceeded 3% of GDP in 1H07	22
FDI inflow reached USD 3.3 billion in 1H07	23
World Bank forecast – USD 8.2 billion of annual FDI by 2012	23



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List of Abbreviations

aop	average over period
CIS	Commonwealth of Independent States
CPI	consumer price index
eop	end of period
EU	European Union
FDI	foreign direct investment
FSTS	First Securities Trading System
GDP	gross domestic product
NBU	National Bank of Ukraine
NEER	nominal effective exchange rate
PPI	producer price index
qoq	quarter over quarter
REER	real effective exchange rate
SSC	State Statistics Committee of Ukraine
UAH	Ukrainian Hryvnia
VAT	value-added tax
WTO	World Trade Organization
yoy	year over year

1. Overview of Economic Development in 2Q07

Ukraine's economy has been slowing down from the beginning of the year largely due to the reduction of industrial growth rates. In 1H07 GDP resulted with 7.9% yoy in real terms, which, however, exceeds the result of the corresponding period in 2006 (5.0% yoy in 1H06). In terms of demand components, GDP growth is supported primarily by private consumption. The decrease in private consumption contribution to GDP in 2Q07 compared to 1Q07 is stipulated by a considerable slow down of household revenues growth.

The cumulative growth rate of total industrial output has been reducing since the beginning of the year due to the slow down (10.4% yoy in June 2007 compared to 15.8% in January 2007) in the major industries.

The first half of 2007 was characterized by a significant decrease in real income growth. Second quarter maintained the trend of quarterly yoy growth of real income - 10.8% (11.1% in 1Q07). While the average quarterly growth in 2006 reached 16.9%, the result of the second quarter of 2007 was the lowest in the last three years.

Price stability during January-April was followed by an upsurge of prices since May. Summer months did not bring seasonal disinflation. During June-July, prices grew by 3.6%, which is the record high value since

2000. Price growth in 1H07 equalled 4.2% (13% yoy).

Money aggregates were accelerating in 2Q07 after moderate dynamics of 1Q07. Reserve money expanded due to forex interventions of the NBU, while money supply was growing on the back of private sector crediting. In 2Q07 monetary base grew by 15.2% and amounted to UAH 111.0 billion. Broad money also accelerated to 11.3% in 2Q07 (3.9% in 1Q07).

During April-June 2007 credits and deposits went up in line with strengthening of economy. Interest rates for credits remained high due to high risk premium set by banks and accelerating inflation. At the same time, deposit rates were falling. Ukrainian banks expanded borrowings on foreign markets which reduced the sector's demand for deposits of households.

Deposits volume grew by 10.1% in 2Q07 which is slight improvement compared to 6.0% in 1Q07. Legal entities were the main deposit contributors for the first time since banking pre-election instability of 2004. Decrease in households' deposits volume should be attributed to political situation. Although households' savings were high in 2Q07, Ukrainians preferred to reduce their holdings at banks.

Table 1.1 Selected indicators, change in %, 2003-2008

	2003	2004	2005	2006	2007(f)	2008 (f)
GDP (change in %)	9.6	12.1	2.6	7.1	6.8	6.9
Domestic demand	12.6	9.4	11.4	13.2	10.4	9.8
Private consumption	12.4	16.3	16.6	14.4	13.1	11.9
Gross capital accumulation	15.8	10.2	-0.3	18.6	13.6	10.1
Industry (value added, change in %)	13.6	10.4	2.0	4.8	8.2	6.6
Market services (value added, change in %)	15.8	13.9	-2.1	11.8	10.1	9.9
CPI (eop., %)	8.2	12.3	10.3	11.6	11.3	10.5
CPI (yoy, aop., %)	5.2	9.0	13.6	9.1	11.3	12.1
PPI (eop., %)	11.2	24.3	9.6	14.2	18.5	10.9
PPI (yoy, aop., %)	7.8	20.3	17.0	9.5	18.2	5.9
Money supply M3 (change in %, aop.)	47.9	44.9	38.6	39.2	34.3	32.1
Current account balance (% of GDP)	5.8	10.6	3.1	-1.5	-3.8	-4.2
Exchange rate (UAH/USD; eop.)	5.33	5.31	5.05	5.05	5.05	5.1
Budget deficit (% of GDP)	0.2	2.9	1.7	0.7	1.9	2.0

Source: State Statistics Committee of Ukraine, CASE Ukraine estimates



NBU continued to buy excess currency supply in the inter-bank currency market in order to maintain fixed nominal exchange rate of UAH vs. USD. All in all, the NBU bought 2.41 billion in 2Q07 (USD 3.4 billion in 1H07).

During April-July the FSTS stock market index grew by 37.8% breaking 1000 points ceiling in mid of June and reached its maximum of 1117.8 p.p. by the end of July. Strong upward movement of the index was interrupted by mortgage crisis in USA which also brought a feeling of uncertainty to Ukrainian market. Thus, by the end of August the FSTS index decreased by more than 10% and was fluctuating around 1000 line.

Strong development of the real sector favours successful execution of the budget plan. In 1H07 fiscal authorities collected 46.7% of the year target (44.5% in 1H06) which is excellent performance for the period. At the same time, expenditures were lagging behind as Ministry of Finance traditionally keeps resources for expenditures in the second half of the year.

In 2Q07, the consolidated budget revenues reached 32.5% of GDP (USD 10.1 billion) which is 0.9 p.p. higher compared to 2Q06. Revenues grew at the expense of personal income tax inflow (PIT) and revenues from property and entrepreneurial activity. Consolidated expenditures also experienced slight increase to 33.4% of GDP (USD 10.4 billion) in 2Q07.

The state debt resumed its growth in 2Q07. The stock of public liabilities increased by 1.8% (USD 0.28 billion) given enlarged external borrowings (+2.8% in 2Q07). The government obligations amounted to USD 15.51 billion (end of June) which is close to 13.1% of GDP.

The privatization process continued in 2Q07 despite political confrontation. However, unstable political environment indeed affected the revenues plan execution. In 1H07 the State Property Fund of Ukraine (SPFU) attracted only 12.5% of the year plan (USD 0.26 billion out of planned USD 2.1 billion).

In 1H07, nominal export of goods and services grew by 28.6% yoy and equaled USD 26.9 billion, while

nominal import accelerated to +32.9% reaching USD 29.3 billion. This led to expansion of trade deficit to USD 2.3 billion compared to USD 1.1 billion in 1H06.

Machinery was among the leaders in terms of export performance in 1H07. This led to increase in the sector's share in overall commodity structure to 15.4% vs. 13.3% in 1H06, which is a positive change. An impressive export performance of Ukrainian machinery was backed by sustained demand in Russia, Kazakhstan, and other CIS economies undergoing restructuring and modernization.

According to preliminary estimates of the NBU, in 1H07 the current account deficit reached USD 1.9 billion and amounted to 3.2% of GDP. Such a deterioration of the current account was triggered by two major factors: i) increase in trade deficit and ii) deterioration of the "income" balance.

According to the State Statistics Committee, the growth of foreign direct investment (FDI) in Ukraine in the first half of 2007 constituted USD 2,553.1 million, which was a 50.3% increase compared to the corresponding period of 2006. Foreign investors injected USD 3,276.3 million in direct investments into Ukraine's economy in the first half of 2007, while withdrawing USD 820.3 million. The stock of FDI in Ukraine as of July 1, 2007 amounts to USD 24,171.8 million.

GDP forecast for 2007 was adjusted to 6.8% yoy in 2007 and 6.9% yoy in 2008 on the base of the data updates. Following the results of the 1H07, we expect industry and market services to remain the major contributors to GDP growth, while agriculture will suffer a decline in value-added. The forecasted industry growth is 8.2% in 2007 and 6.6% in 2008, and the slowdown is related to the decreased external demand for the Ukrainian exports, primarily metallurgy production.

Our CPI forecast of 9.4% (eop) for 2007 was revised upwards to 11.3%. In 2008 slight CPI deceleration to 10.5% is expected. Scheduled imported gas price increase in 2008 is one of the key risks of inflation in 2008.



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