Economic Performance in 2007 and Outlook for 2008

The Ukrainian economy continued to show robust growth, demonstrating strong resilience to energy price shocks and a solid immunity to political instability and global financial turmoil. According to preliminary estimates of the State Statistics Committee of Ukraine, GDP grew by a real 7.3% year-over-year (yoy) to about UAH 700 billion ($140 billion), notably exceeding the 6.5% yoy growth expected at the beginning of the year. With average real GDP growth of 7.8% per annum over the last five years, Ukraine was among the fastest growing economies in the region.

In 2008, the Ukrainian economy is expected to grow by about 5.5%. Slower real GDP growth compared to 2007 will reflect a 38% increase in the cost of imported natural gas as well as more difficult forecasted external conditions. On the back of generous social payments from the budget and fast growth in wages, private consumption is likely to remain the main driver of economic growth. At the same time, tighter monetary policy as well as the global credit squeeze will hinder commercial banks’ ability to expand their credit portfolios at a pace comparable to previous years. With the limitations in the availability of bank credit, consumption and fixed investments may report slower growth than in 2007.

Inflation and a widening current account deficit will be the main macroeconomic challenges for Ukraine in 2008. Consumer prices are expected to grow by 13–15%, even assuming no significant pass-through of retail gas prices to consumers. The current account is forecasted to widen to about 6% of GDP. But it will be fundable thanks to robust FDI inflows and continuing (though slower) growth of private sector borrowings from abroad. Considering the rapid widening of CA deficit, the likelihood that the National Bank of Ukraine will allow them will be significantly lower than expected at the beginning of the year. Construction works expanded by a real 15.8% yoy in 2007. Of the total volume of construction works, 85.8% were for construction of entirely new buildings and which grew by 16.1% yoy. In 2007, Ukrainian transport enterprises carried 5.4% and 7.2% more goods and passengers than in the previous year, respectively.

Economic Growth

In 2007, economic growth was underpinned by buoyant consumption and investment growth as well as a favorable external environment. Private consumption was the leading factor contributing to GDP growth in 2007. In turn, it was supported by a continuing credit boom and strong growth in real disposable income of households (up by 12.8% yoy in 2007). Despite a prolonged period of political instability, the strong increase in investment demand was driven by the growing need to renovate existing production capacities in order to meet growing input costs and intensifying competition, as well as infrastructure expenditures and realization of Greenfield projects. Though robust domestic demand and high energy prices enhanced the growth of imports, benign external conditions (i.e., higher world steel prices than expected at the beginning of the year, strong investment demand in Ukraine’s main trading partner countries, particularly Russia) supported Ukraine’s export performance.

On the supply side, GDP growth was propelled by double-digit value added growth in wholesale and retail trade, construction, industry as well as solid growth in transportation and communication. In particular, retail sales turnover grew by 29.3% yoy in 2007, while wholesale trade turnover advanced by a strong 12% yoy in the first nine months of the year. Construction works expanded by a real 15.8% yoy in 2007. Of the total volume of construction works, 85.8% were for construction of entirely new buildings and which grew by 16.1% yoy. In 2007, Ukrainian transport enterprises carried 5.4% and 7.2% more goods and passengers than in the previous year, respectively.

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tax privileges (several free economic zones), a
slow privatization process and the likely relax-
ion of fiscal discipline due to political
taxes (such as value added tax) could have been
higher. Thus, receipts from VAT were just
17.8% yoy higher in 2007 in nominal terms.
Taking into account that VAT is principally a
tax on consumers, a 12.4% yoy real increase in
domestic consumption and faster-than-expected
inflation should have been translated into
higher proceeds. Below-target VAT proceeds
may be attributed to re-installment of several
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Buoyant domestic demand and benign external
conditions resulted in growing profitability of
Ukrainian enterprises. According to the SSC of
Ukraine, about 2/3 of enterprises reported prof-
its before taxation over 11 months of the year
(65.8% in January-November 2006), which were
higher by a nominal 64.5% yoy. As a re-
sult, receipts from corporate profit tax grew by a
nominal 35% yoy in 2007.
During the first eleven months of the year, the
central government authorities maintained low
fiscal deficits, under-fulfilling expenditures, in-
cluding transfers to the local budgets. Consider-
ing over-execution of revenues (as PIT is the
main source of local budget revenues), local
budgets reported large surpluses, which out-
paced the state budget deficit. A sluggish privat-
ization process was among the primary reasons
for below-target expenditures. According to the
2007 state budget law, the government planned to
receive UAH 10.6 billion ($2.1 billion) from
privatization, while actual proceeds amounted
to only 23.2% of the target. However, faster
than expected nominal GDP growth and govern-
ment debt placement on both domestic and ex-
ternal markets resumed in the second half of
2007, allowing the state government to catch up
with expenditures in December. In that month
alone, the government spent about UAH 25.4
billion ($2.2 billion) compared with average
monthly fiscal spending at UAH14-15.5 billion.
Thanks to a 5.5% over-execution of revenues, the
state budget reported a deficit in 2007 that was
almost twice as low as was planned in the
budget law1. At the same time, local budget ex-
penditures lagged behind the targeted amounts
by about 4%, generating a total surplus of UAH
2.1 billion. As a result, the consolidated budget
deficit constituted UAH 7.7 billion, represent-
ing about 1.1% of estimated GDP in 2007, con-
siderably below the 2.4% of GDP level fore-
ceasted at the beginning of the year.
About 1/3 of the consolidated budget deficit in
2007 was financed through privatization re-
cipts and the rest through public borrowings.
Following the placement of Eurobonds in June
and November, the government received $1.3
billion into state coffers, while regular issu-
ance of domestic securities during June-Dec-
ember brought UAH 3.7 billion ($0.7 billion).
Several infrastructure loans, which were pro-
vided to Ukraine by several International Fi-
nancial Institutions under state guarantee,
drove external publicly guaranteed debt up by
about 14% yoy. The issuances of mortgage
bonds by the State Mortgage Institutions in
June and September, aimed at reducing the
cost of mortgages to the public, were responsi-
ble for an increase of domestic publicly guaran-
teed debt from $0.19 million at the beginning
of the year to about $200 million at the end of
2007. Therefore, despite quite sizable prin-
cipal payments (of about $1.3 billion) in 2007,
total public and publicly guaranteed debt in-
creased by 10.2% yoy to $17.6 billion. How-
ever, thanks to faster nominal GDP growth, the
debt-to-GDP ratio continued to decline and
was less than 13% of estimated 2007 GDP.
In 2008, the government plans to borrow about
UAH 16 billion ($3.1 billion). About 63% of at-
ttracted funds will be directed to finance the
state budget deficit, targeted at UAH 18.5 bil-
lion ($3.7 billion or 2.1% of forecasted GDP).
The rest will be spent on principal payments
due in 2008 (UAH 5.9 billion or $1.2 billion).
Global financial turmoil is likely to increase
the cost of borrowing resources from abroad
for both the public and private sector. Hence,
the government has increased its reliance on
domestic financing as its share in total deficit fi-
nancing will grow from less than 1/3 in 2007 to about 1/2 in 2008. This may enhance further development of the Ukrainian stock exchange and may diminish the vulnerability of the economy to adverse exchange rate shocks. Although in nominal terms total public and publicly guaranteed debt will increase, in terms of GDP it will continue to decline in 2008, though at a slower pace.

As in 2007, the government plans to receive rather generous privatization proceeds — UAH 8.6 billion ($1.7 billion). However, unlike the previous year, the 2008 privatization plan is likely to be better executed. At the end of January, the government approved an extensive list of enterprises to be privatized in 2008, including Odessa port chemical plant, telecommunication monopoly Ukrtelecom, and controlling stakes of several power supply companies (oblenergos), which, if realized, may result in higher than planned privatization receipts. In addition, budget revenues may be higher than expected in 2008 due to a higher inflation rate. The 2008 state budget law was developed with a 9.6% yoy inflation forecast, while the actual rate of price growth is likely to be 13-15%. Despite the temptation to use extra budget and privatization revenues to further raise budget expenditures, we believe that the government may restrain from further expenditure increases due to mounting inflationary pressures.

Monetary Policy
Consumer inflation surged by 16.6% yoy in 2007, notably exceeding initial expectations. The highest inflation rate since 2000 was the result of both supply and demand side factors. On the demand side, inflation was driven by wage growth in excess of productivity during the last couple of years and the continuing credit boom. On the supply side, rallying prices on imported energy resources and other commodities and poor agricultural performance were the primary reasons for galloping inflation. In addition, producer price inflation continued to spillover into the retail markets. In 2007, producer prices grew by 23.2% yoy, notably outpacing consumer price growth. The gap may be explained by a full pass through of higher energy prices on producers on the back of limited adjustment of utility tariffs for households and the existence of price regulations on socially important products, for instance bread. Moreover, despite the fact that the official hryvnia to US dollar exchange rate remained stable, depreciation of the US dollar with respect to other world currencies (particularly the euro and ruble) made imported goods and service prices (which were denominated in these currencies) more expensive for Ukrainian consumers.

Monetary expansion has also contributed to the rise in inflation. Indeed, money supply (M3) grew by 52.2% yoy in 2007 with cash in circulation increasing by 48.2% yoy. At the same time, a sharp acceleration of monetary aggregates occurred in December (monetary base and M3 grew by 34.1% and 40% year-to-date as of the end of November 2007), as a result of a typical fiscal loosening at the end of the year. According to NBU data, cash balances on government accounts with the NBU grew 67.4% over January-November to UAH 15.3 billion and sharply declined to just UAH 4.4 billion as of the end of December.

Robust inflow of foreign capital under the NBU policy of keeping the hryvnia exchange rate stable has also induced the growth in monetary aggregates. In 2007, net purchases of foreign currency by the National Bank of Ukraine amounted to about $8 billion and were responsible for almost 90% of monetary base growth in 2007. On the upside, the accommodative monetary policy allowed the NBU to increase its international reserves by $10 billion to $32.5 billion at the end of 2007. 2007 was another year of exponential growth in domestic credit by the banking system, which in turn was responsible for the robust expansion of monetary aggregates. Rapid growth of deposits (up by about 52% yoy) as well as aggressive borrowing from abroad allowed the commercial banks to expand their credit portfolios by an impressive 74.1% yoy in 2007. As external financial resources turned out to be cheaper than domestic ones, commercial banks offered more attractive interest rates on credit denominated in foreign currency. The prolonged period of a relatively stable exchange rate may have resulted in households and legal entities belittling the possible adverse exchange rate risk. Taking into account more attractive interest rates, borrowers still preferred foreign currency denominated loans. At the same time, due to financial turmoil on international markets in the second half of 2007, which made external finances more expensive, as well as NBU measures to restrain the growth of foreign currency denominated loans, hryvnia-denominated loans have been gathering momentum while the growth of forex-denominated loans has been slowing down. In particular, hryvnia-denominated credits grew by almost 73% yoy, up from 52% yoy in 2006, while
Inflationary pressures will remain high in 2008. Even without the pass-through of higher energy prices to consumers, inflation may reach 13-15% due to continuing robust consumption growth (though slower than in the previous year), shortages on the food market in the first half of the year, and rallying commodity prices on international markets. Though expansion of monetary aggregates was not the leading factor causing inflation to skyrocket in 2007, the NBU has started to implement the policy of right money by introducing reserve requirements on funds attracted by commercial banks from abroad in November 2007 and raising its discount rate by 200 basis points to 10% since the beginning of 2008. However, considering the rather weak transmission mechanism and mostly non-monetary nature of inflation, the situation may require further tightening as well as more coordinated measures with the government.

International Trade and Capital

In January-November, Ukraine’s merchandise exports grew by almost 28% yoy, up from 27.4% yoy in January-October. Acceleration occurred thanks to faster growth in export of chemical, agricultural and mineral products, machinery and transport equipment. Rallying commodity prices on international markets were responsible for 36.8% yoy and 19.1% yoy growth in export of minerals and chemicals respectively. Favorable by strong investment demand in Ukraine’s main trading partner countries, export of machinery and transport equipment advanced by a robust 54.4% yoy in January-November 2007. At the same time, metallurgical exports, the largest commodity group accounting for about 45% of total merchandise exports, continued to slow down. Stabilization of world steel prices and deceleration of production due to unanticipated shortages in coking coal, an important input for steel production, were the primary reasons for export deceleration of metallurgical products to 26.1% in January-November, down from 27.4% yoy reported for the first ten months of the year.

Despite strong export performance, the merchandise trade balance continued to deteriorate due to fast growth of imports. Robust private consumption and strong investment demand, as well as high world prices on energy resources and other commodities, caused CIF imports to expand by 34.2% yoy to $54 billion at the end of November. A worsening trade balance was the primary reason for the widening current account deficit. According to the National Bank of Ukraine, the CA gap reached $4 billion over the first eleven months of the year. Nevertheless, the outstanding inflow of foreign capital more than covered the CA deficit. In fact, net FDI inflow is estimated to reach a record high $8-8.5 billion.

In 2008, Ukraine’s current account balance is forecasted to continue worsening. The negotiated 38% rise in the price for imported natural gas and forecasted robust growth of domestic demand will enhance fast growth of imports. At the same time, the growth of imports is likely to decelerate compared to 2007 due to slower demand growth caused by less buoyant credit growth. Export is also likely to decelerate, though we assume world steel prices will remain high. The deceleration will be caused by the slowdown in the world economy, the likely shortages of raw materials (i.e., coking coal) and growing competition on external markets. As a result, the CA deficit may widen to 6% of GDP in 2008. At the same time, the gap will still be fundable due to another year of record high FDI inflow and continuing private sector borrowing from abroad (though external conditions are likely to be less favorable in 2008).

Other Reforms Affecting Investment Climate

In Geneva on February 5th 2008 at the session of the General Council of the WTO, President of Ukraine Viktor Yushchenko and the WTO’s Secretary General Pascal Lamy signed the protocol on Ukraine’s admission into the WTO. However, to become a full WTO member, Ukraine still has to adopt and/or amend about 11 laws and a number of other legislative documents, and ratify the signed agreement by July 4th at the latest. Membership in the WTO will be a positive signal for investors. Though beneficial for some sectors of the Ukrainian economy (such as metallurgy and the chemical industry), joining the WTO may be challenging for others (i.e., agriculture and machine-building). At the same time, a 5-year grace period and general improvement in business climate will help Ukraine sustain economic growth and attract larger investments.