Summary

- In July, economic growth accelerated to 7.3% yoy due to a strong recovery in agriculture, bringing the cumulative growth back to 6.5% yoy. At the same time, continuing value added growth deceleration in other sectors gives reason to expect moderation of economic growth to about 6.3% yoy for 2008, despite a record high harvest.
- Thanks to above-target revenues and controlled expenditures, the consolidated budget balance was positive, reporting a 1.5% of GDP surplus in the first half of 2008. Despite good fiscal performance so far, the fiscal outlook for the rest of the year remains uncertain considering the sluggish privatization process, tighter borrowing conditions, increased expenditures related to unfavorable weather conditions and government plans to amend the 2008 budget raising further social liabilities.
- Inflationary pressures continued to soften as consumer prices fell by 0.5% month-over-month in July. However, reducing annual inflation below 20% may still be a challenging task for Ukrainian authorities.
- On the back of surging world commodity prices, Ukraine demonstrated record high export growth. However, the growth of imports kept outpacing exports, triggering further deterioration of foreign trade and, thus, current account balances.
- Though the economic links between Ukraine and Georgia are quite modest, the recent Russia-Georgia conflict may have far-reaching consequences for the Ukrainian economy.

Economic Growth

Abrupt GDP growth deceleration in June was taken as a tentative sign of macroeconomic adjustment. However, GDP growth bounced back in July to 7.3% from a year earlier, bringing cumulative growth to 6.5% yoy. The upsurge is mainly attributed to a recovery in agriculture, which more than offset weakening growth in industry and domestic trade, as well as a continuing slowdown in construction, education and healthcare.

Value added growth in agriculture reached 10.8% yoy for January-July backed by an outstanding harvest this year. As of August 1st, Ukraine had harvested 26.3 million tons of grain from about 60% of the total area under grain crops. Despite the recent floods that affected western Ukraine (which accounted for about 15% of total grain production in 2007), the grain crop is expected to top 43 million tons, a 15-year record amount. The increase in the overall harvest is attributed to good weather as well as an increase in planted area as the rise in food prices (both domestically and globally) was a strong incentive for agricultural producers.

The rich harvest this year will help to ease inflationary pressures in the country as soaring food prices were the main driver of consumer inflation since the second half of 2007. At the same time, while consumers take advantage of falling agricultural prices, producers (particularly small farm enterprises) may not fully reap the expected profits. In July, the average price of wheat on the domestic market was UAH 807.5 ($166.5) per ton, representing a fall of almost 20% from June’s level and about 27% from March’s peak. Given strong external demand, Ukraine’s grain exports may reach about 17.5 million tons\(^1\), which would prevent a sharp fall in domestic prices, thus maintaining the financial stance of agricultural producers. However, due to limited storage capacities and outdated and/or insufficient infrastructure, this potential may not be fully realized. Consequently, falling domestic prices on the back of rising production costs (due to more expensive fuel, fertilizers, freight, storage, etc.) may drag agricultural production down in the future. Indeed, despite possessing extensive black soil and having favorable climate conditions, Ukraine’s agricultural performance has been rather disappointing. Insufficient investments, stemming from slow structural reforms, have turned Ukraine into a net importer of grain during 2000/2001 and 2003/2004. Over the last five years, the average crop yield was 45–50% lower than in the EU-27.\(^2\)

Supply side constraints and existing inefficiencies in the agricultural sector were among the main causes of recent spikes in food prices. Timely and consistent implementation of comprehensive agricultural reform will help to expand crop production and other agricultural products, ensure a smooth food supply on the domestic market and build a competitive agricultural sector.

Over January-July, value added growth in the mining sector accelerated to 5.7% yoy. Faster growth in the sector was achieved thanks to an 8.2% yoy rise in output of non-energy minerals production and a 2.4% yoy increase in extraction of fossil fuels. Ukrainian producers and exporters of iron ore are taking advantage of booming iron ore prices, underpinned by strong demand for steel products in developing countries (particularly China, Russia and India). High world energy prices (crude oil and natural gas) on the back of falling domestic production of these commodities stimulated extraction of thermal coal, which grew by 6.8% yoy in the first half of the year. Production of other fossil fuels, however, continued to decline. Thanks to robust domestic and foreign trade, rising household disposable income (up by a real 14.7% yoy over the first half of 2008), value added in transportation and communication grew by 8.4% yoy, an unchanged rate compared to the first six months of the year.

Other sectors, however, demonstrated weaker growth. Industrial production continued to decelerate, demonstrating a 7.3% yoy increase in January-July compared to 7.5% yoy in 1H 2008. Growth in food processing slowed to 4.4% yoy, as a poor 2007 harvest...
According to data released from the State Tax Administration of Ukraine at the beginning of July, thanks to the introduction of electronic administration of VAT, it identified about 170 companies that manipulated taxation production of oil products. To a growth slowdown in the industrial sector continued to be among the main contributors these products affected by slower credit distribution just recently started to function, it is expected that value added growth in domestic trade sector will continue to decelerate. In turn, this will negatively contribute to total GDP growth, as the sector accounts for almost 13%. Given also weaker growth of industrial production and continuing depression in construction, GDP growth may slow to 6.3% yoy for the whole year, regardless of the remarkable harvest this year.

Fiscal Policy

Over the first half of 2008, the consolidated budget posted a surplus of UAH 6.5 billion ($1.3 billion), which is equivalent to 1.5% of period GDP. The surplus was achieved thanks to over-fulfillment of consolidated budget revenues and below-target expenditures. Consolidated budget revenues were up by about 44% yoy in nominal terms, primarily on account of an almost 50% yoy rise in tax collections. Proceeds from VAT rose by a nominal 60.4% yoy over the first half of 2008, reflecting robust economic growth, high inflation, buoyant imports, and improved tax administration. Modernized customs procedures secured a 91% yoy increase in import duties, while strong growth in household income and improving profitability of Ukrainian enterprises allowed for collection of 41% yoy and 53.3% yoy higher proceeds from personal income and corporate profit taxes respectively. At the same time, the growth rate of tax collections in January-June was slightly lower than in the preceding period, which may be attributed to gradual cooling of the economy (in June, economic growth notably decelerated to 5.4% yoy versus 7.2% yoy in May).

Despite strong growth in fiscal revenues, the consolidated budget surplus shrank almost in half in January-June compared to January-May, which may be attributed to better execution of budget expenditures as well as higher spending from the reserve fund. In particular, expenditures from the general fund of the state budget were under-fulfilled by 5.5%. At the same time, the annual growth of consolidated budget expenditures slowed to a nominal 46.8% in January-June versus about 50% in the previous period. The deceleration may be attributed to a high statistical base effect as the government started the second stage of implementing the Unified Tariff Scale for setting public sector employee salaries in June of last year, while realization of the next stage is expected that value added growth in domestic trade sector will continue to decelerate. In turn, this will negatively contribute to total GDP growth, as the sector accounts for almost 13\%. Given also weaker growth of industrial production and continuing depression in construction, GDP growth may slow to 6.3% yoy for the whole year, regardless of the remarkable harvest this year.

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Natural gas tariffs for heating and power engineering enterprises remained unchanged since mid-2006.

Monetary Policy

The anti-inflationary program, which included stricter monetary policy, appreciation of the national currency and tight control over fiscal expenditures, started to bear fruit amid an increasing supply of new harvest products. For the first time since April 2006, consumer prices fell by 0.5% month-over-month (mom) in July 2008. In annual terms, the disinflation trend strengthened as consumer price index growth declined to 26.8% in July, down from 29.3% in the previous month. Deceleration of consumer price increases was attributed to a declining trend for foodstuffs prices. Last year, unfavorable weather conditions, loose credit conditions as well as expansionary fiscal policy caused a sharp acceleration in food prices. Conversely, the good harvest this year coupled with NBU/government measures to curb inflation contributed to a 1.3% mom reduction in food prices, which brought annual growth down to 39% versus almost 44% yoy in June. Fruits, vegetables and meat products respective price growth decelerated to 70.6% yoy, 3% yoy and 52.9% yoy in July versus 79.1% yoy, 33.1% yoy and 54.3% yoy in June. This was the most significant contributor to easing food inflation, offsetting the continuing increase in prices for bread, fish and fish products, sugar and confectionery.

However, despite a positive trend, it is too early to see inflation relief. First, non-food and service tariffs inflation continued to pick up. In particular, growing utility tariffs (up by 12.3% yoy in July vs. 11.5% yoy in June), more expensive household appliances (up by 7.2% yoy in July), city transportation (up by 33.4% yoy), education and recreation services (up by 19.3% yoy and 15.4% yoy respectively) led to higher overall prices in the economy. Moreover, despite easing world crude oil prices, Ukraine's retail fuel prices continued to pick up (by 47% yoy in July vs. 42.5% yoy a month before). Second, easing inflation provided some room for government authorities to allow a gradual pass-through of higher energy prices to consumers. Starting September 1st, tariffs for natural gas will be raised by about 13%-14% for households, the public sector and heating enterprises. The tariffs have remained unchanged since the end of 2006, although the price for imported natural gas (which accounts for almost of Ukraine's total natural gas consumption) grew by about 38% at the beginning of 2008.

Monetary and exchange rate policies bore mixed results so far. The tightening of reserve and capital requirements, raising the NBU discount rate to 12%, sizable sterilization operations at the end of 2007/beginning of 2008 and appreciation of the national currency helped to subdue buoyant money supply and credit growth, thus contributing to easing inflation. These measures, however, led to notable liquidity strains in the Ukrainian banking sector, requiring the NBU to support commercial banks with extra liquidity through its refinancing operations. During May-July, the NBU provided...
commercial banks with UAH 27.1 billion ($5.6 billion). Moreover, high domestic interest rates attracted robust foreign capital inflow to Ukraine. To prevent a sharp national currency appreciation, the NBU had to intervene on the inter-bank forex market by buying out the surplus of foreign exchange. In July alone, net NBU purchases of foreign currency amounted to $2.5 billion and reached $4.5 billion for the last three months. Sizable forex interventions spurred the National Bank to partially sterilize these amounts. In July, it withdrew UAH 10.3 billion ($2.1 billion) from the market. The combined result of these measures, however, was acceleration of monetary base growth to 41.6% yoy in July (up from almost 39% yoy in June).

At the same time, money supply (M3) growth decelerated to 47.5% yoy, down from 48.7% yoy in June, which was attributed to slower deposit growth. The latter, in turn, may be explained by a reduction of the hryvnia deposit rate amid improved banking sector liquidity. At the same time, the importance of this source for banks’ credit creation may increase in the coming months as starting August 1st the NBU raised reserve requirements for commercial banks’ foreign funds attracted for less than 6 months to 20% (up from previous 4%). So far, the growth of commercial banks credit portfolios slowed to 61.1% yoy in July. The NBU has been purposefully cooling credit growth, in response to growing concerns over banking sector vulnerability to various risks as well as the realization that the credit boom over the last several years notably contributed to inflationary pressures by driving consumption.

At the beginning of July, the government revised its year-end inflation forecast upwards to 15.9% yoy, up from the previous 15.3% yoy. However, given the above arguments, even the revised forecast looks overly optimistic, despite easing inflationary pressures in June-July. We forecast inflation to reach about 20% yoy this year.

International Trade and Capital

Surging world commodity prices supported Ukraine's strong export performance. In June, export of goods picked up by a record high 62.7% yoy, bringing the cumulative merchandise export growth to 40.7% yoy. By product breakdown, ferrous metals (up by 57% yoy over January-June), chemicals (up by 28.4% yoy), machinery and transport equipment (up by 44.3% yoy) were the main contributors to total export growth. Following the enlargement of grain export quotas in April and their elimination at the end of May, export of agricultural products accelerated to 31.8% yoy in January-June, up from 27.8% yoy in the previous period. In addition, growth of mineral products exports (mainly gasoline and coal) contributed strongly to the overall growth of merchandise exports, as their sales to foreign partners increased by 56.8% yoy in the first half of 2008, up from 27.3% yoy in January-April.

Despite remarkable export performance, Ukraine's foreign trade balance continued to deteriorate as imports growth also sped up. On the back of high commodity prices and strong domestic consumption, imports of goods grew by 69.3% yoy in June, bringing cumulative growth to 55.3% yoy. Energy resources and machinery and transport equipment, the import values of which were up by 51% yoy and 60% yoy respectively, were the main contributors to total merchandise import growth. As a result, the FOB/CIF merchandise trade deficit reached $9.8 billion, 2.3 times higher than in the first half of 2007. Considering merchandise trade performance, the current account gap this year may reach $14.4 billion. However, strong FDI inflow and still robust private sector borrowing from abroad will cover the forecasted CA gap.

Other Developments Affecting Investment Climate

At the beginning of August, Moody's Investors Service affirmed Ukraine's long-term foreign and local currency ratings. The agency acknowledged declining external public debt, controllable fiscal situation and high international reserves. However, the rapidly widening current account gap amid volatile international financial markets was among the main reasons for keeping the rating unchanged. According to agency estimates, FDI inflow will cover the CA deficit by 80% in 2008, increasing the country’s dependence on foreign financing in an uncertain environment.

The recent military confrontation between Georgia and Russia may have mixed but crucial consequences for Ukraine. Impact in the short-term on the Ukrainian economy is likely to be minimal as the economic links between Ukraine and Georgia are quite modest, but the conflict uncovered the latent flashpoints that could affect investor sentiments about Ukraine. With a prolonged common history with Russia and a large ethnic Russian minority, Ukrainian society remains highly divided in choosing pro-Western or pro-Russian development. Following Viktor Yushchenko's victory in the 2004 presidential elections, the country declared its desire to join NATO and seek EU integration, a direction discordant with Russia’s efforts to retain its influence on former Soviet republics. Moreover, according to the lease agreement signed in 1997, Russia's Black Sea fleet, which was directly involved in the Russia-Georgia conflict, will be based in Crimea until 2017. Many political forces in Ukraine believe that this agreement should not be renewed, a position that would antagonize Russia. Furthermore, the conflict may spur Ukraine's aspirations to join NATO, which may further worsen Ukraine-Russia relations. Although it is very unlikely that the "Georgian scenario" can play out in Ukraine, the rising geopolitical tensions in the region may adversely affect investor sentiment, which in turn may translate into lower FDI inflow and growing costs of borrowed resources for Ukraine. Furthermore, Ukraine's energy-intensive economy is almost entirely dependent on Russia's energy imports. Deterioration of Ukraine-Russia relations in the aftermath of the Russia-Georgia conflict may result in a sharp increase in imported natural gas prices next year. Though Ukraine demonstrated strong resilience to energy price shocks, a combination of higher energy prices, the coming presidential election and a fragile external environment caused by financial distress on international markets and a generally over-heated domestic economy may drag down economic growth in the coming year.