Ukrainian Economy

Quick Stats

	Change from H2 2008	Change from H1 2008
GDP	↓	↓
Unemployment	↑	↑

Hot Topics

- The economic situation has deteriorated substantially over H1 2009, but first signs of stabilization – particularly, on the supply side – surfaced towards the end of Q2.
- With the global crisis exposing numerous weaknesses of the nation's economy, Ukraine now finds itself in urgent need to finally implement serious structural reforms.

POLITICS AT A GLANCE

Continued political instability coupled with chronic economic dislocation threatened to seriously destabilize the nation as a whole, but remained largely subdued over the first six months of the year. The much anticipated social unrest did not materialize, as the general public continued to react with usual apathy. The question over the precise timing of the presidential vote has also been resolved, following the ruling by the Constitutional court in May against early elections in October and subsequent Parliament's decision to schedule the vote for January 17th, 2010. The rest of 2009 is therefore unlikely to see people going to the polls. Instead, the second half of the year will be marked by a power struggle in the upcoming presidential campaign, which could unleash detrimental populist politics. Furthermore, there are risks that the forthcoming gas talks with Russia towards the end of the year could cast a shadow over the campaign if not influence the results altogether.

The state of international affairs offered more grounds for optimism. Negotiations are under way with the EU on an extensive free-trade deal, with politicians on both sides claiming that agreement may be reached by the year end. Likewise, Ukraine's progress on the International Monetary Fund (IMF) program has been largely successful, ensuring three tranches of funds – in excess of $10 billion combined – following a string of policy adjustments in monetary and fiscal areas.

ECONOMIC OVERVIEW

Executive Summary

Following the spread of global financial turmoil to Ukraine in H2 2008, the economy has suffered a sharp reversal due to the combination of curtailed financing and reduced external demand. The ensuing economic adjustment has been swift and dramatic, with most macroeconomic indicators continuing to deteriorate in double-digits y-o-y terms in Q2 2009. While policy response has been buttressed by the IMF's funds, the broader economy is unlikely to witness a significant turnaround in 2009. Nevertheless, a large hidden economy and a solid base of household savings should offer some cushion against the effects of the present recession.

Ukraine Fact Sheet

Annual data	2008*	Historical Averages (%)	2004-2008
Population (million)	46.0	Population growth	-0.6
GDP (US$ billion; market exchange rate)	180.3	Real GDP growth	6.4
GDP (US$ billion; purchasing power parity - PPP),	336.7	Real domestic demand growth	12.3
GDP per head (US$; PPP)	7,320	Inflation	13.8
Exchange rate (av) UAH:USD	5.27**	FDI inflows (% of GDP)	6.0

Source: Economist Intelligence Unit (EIU)
* EIU estimates; ** actual data

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Economic policy

With the IMF mission now active in Ukraine, the authorities have been implementing fiscal and monetary policies in line with the conditions set for the provision of the $16.4 billion, 24-month stand-by loan approved in October 2008. In July the IMF delivered a generally favorable assessment of Ukraine's progress and has pledged to disburse the third tranche of assistance. This positive result of the IMF review represents a beneficial development and can serve to bolster confidence in the country's economic policymaking.

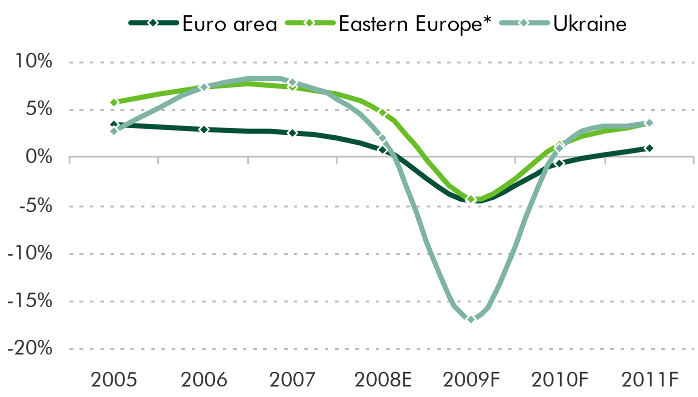
Among key positive steps undertaken by the authorities most recently, has been the resolution (passed by the National Bank), whereby the official exchange rate will be set on the basis of interbank exchange rate, thereby paving the way for possible future broader currency liberalization. Furthermore, the government has stepped up efforts to support budget revenues by raising excises on tobacco and alcohol and pledging to bring domestic utility prices in line with market levels as well as taking measures to improve the financial position of the Pension Fund. These steps, while being generally unpopular, should work towards making the Ukrainian economy more competitive in the long run.

ECONOMIC GROWTH

After contracting at a record pace in q4 2008 and q1 2009, the economy showed the first signs of stabilization in q2 2009. The supply side in particular appeared to have bottomed out with industrial production being effectively flat at -31% y-o-y for four consecutive months and annual construction works actually improving to -54.9% in June from -57.6% in January. Overall, with services sector activity equally nose diving amid a worsening business environment, agricultural output, which grew 2.6% y-o-y over January-June, remained the only component to support GDP on the production side.

The situation on the demand side, however, continued to deteriorate. Specifically, trends in retail sales indicate that the bottom in terms of domestic consumption is yet to be reached, notwithstanding a recent improvement in consumer sentiment. In the year to July, the rate of decline of retail turnover reached 15.2% y-o-y on the back of 10.4% fall in real wages and much weakened local currency (UAH). Excessive foreign borrowing, which fuelled the previous consumption boom, became the main reason for a hard fall in private spending once the credit dried up and depreciated UAH significantly increased debt-servicing costs.

GDP Growth – Ukraine vs. the Region

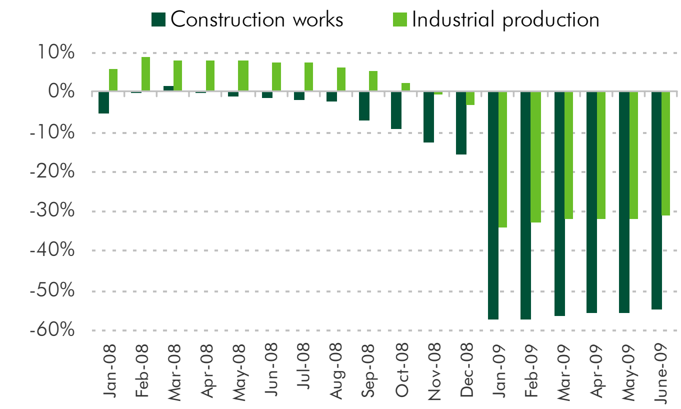


Source: EIU

E – EIU estimates; F – EIU forecasts.

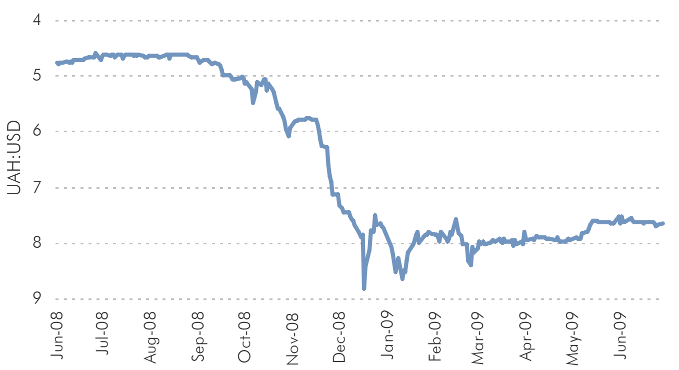
*Azerbaijan, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Kazakhstan, Latvia, Lithuania, Poland, Romania, Russia, Slovakia, Slovenia and Ukraine

Construction Works and Industrial Production (% change, y-o-y)



Source: State Statistics Committee

Exchange Rate on the Interbank Currency Market (weighted average)



Source: National Bank of Ukraine

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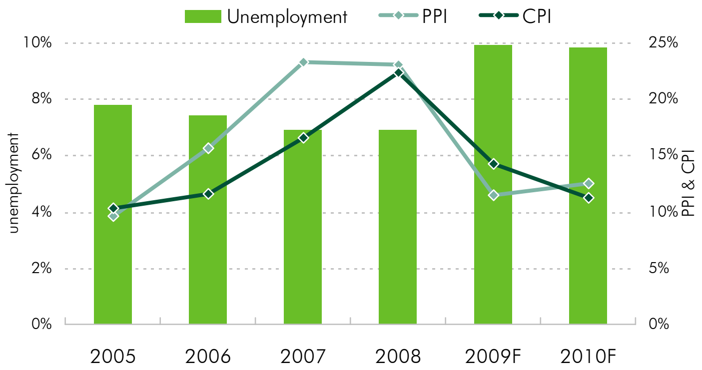
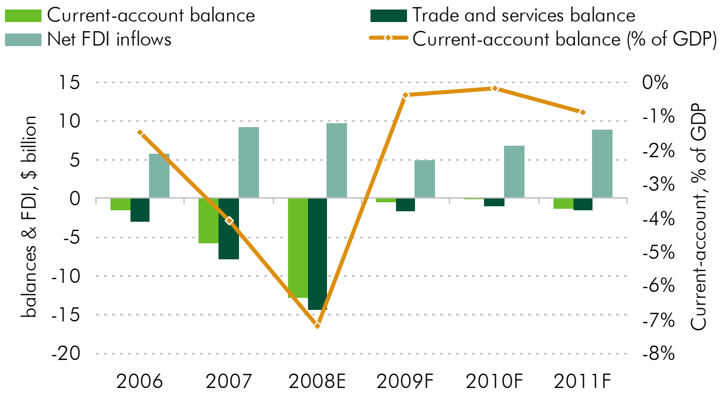
Unemployment and Inflation



Source: State Statistics Committee, Dragon Capital

F – Dragon Capital forecasts (prices), IMF forecasts (unemployment)

External Sector



Source: EIU

E – EIU estimates; F – EIU forecasts.

2009 & 2010 Forecasts

Key indicators	2009	2010
Real GDP Growth (%, y-o-y)	-13.60	1.90
Private Consumption (%, y-o-y)	-12.71	1.30
Consumer Price Inflation (%, y-o-y)	16.01	10.60
Unemployment (ILO, %)	10.40	9.57
Consolidated Budget Balance (% of GDP)	-6.03	-3.15
Current-Account Balance (% of GDP)	-0.04	-0.01
Exchange Rate UAH:USD (av)	8.05	8.14

Source: averages derived from the latest forecasts provided by Dragon Capital, Economist Intelligence Unit, Goldman Sachs, International Center for Policy Studies (Ukraine), Institute for Economic Research and Policy Consulting (Ukraine), International Monetary Fund, Unicredit bank and World Bank.

General instability in the debt-ridden banking sector has also played on consumer fears, prompting widespread deposit outflows. However, the state's progress on recapitalization of the banking sector brought some stability towards the end of q2. Deposits flows were positive in May for the first time since December (and increased by additional 0.8% in June), while banks managed to repay or refinance some 50% of their foreign debt obligations due for repayment in 2009. Overall, the initial chaos in the banking sector witnessed over q4 2008 seems to be over, underlined by the NBU's decision to allow pre-term deposit withdraws.

PRICES AND UNEMPLOYMENT

Significant slowing of inflation was among key positive developments witnessed over H1 2009. Consumer Price Index (CPI) rose 8.6% during January-June, taking the y-o-y rate to 15.0% – a relatively mild level in historical terms. Stabilization of exchange rate is the main factor behind disinflation, but large contraction in domestic demand has also eased price pressures.

Surprisingly perhaps, official unemployment rate is declining, although it has never been an accurate interpretation of labor market conditions. While data analyzed by the Labor Organization (ILO) has not been released, experts estimate the current unemployment rate at no less than 8%, versus 6.9% six months ago.

EXTERNAL SECTOR

Having hit a record deficit of $12.9 billion in 2008, the current-account balance smoothed out for the first time in three years – spurred by the improvement of trade balance – and was in the red by only $0.7 billion in the year to July.

The factors that contributed to high current-account deficits in the past have shifted dramatically into reverse over the last months. A credit-induced consumption boom ended, just as a weaker currency began to favor domestically-produced goods, thereby leveling off the trade balance. However, while the global financial and economic conditions remained volatile, the inflows of net foreign direct investment (FDI) slowed down substantially reaching ca. $2 billion over H1 2009, in contrast to the ca. $5.5 billion invested over the same period a year ago. The banking sector was the principal beneficially of FDI inflows in H1 2009, as foreign banks supplied capital in an attempt to recapitalize their local subsidiaries.

OUTLOOK

We do not anticipate the economy to bounce back in 2009, but broader stabilization of external and domestic conditions is definitely on the cards. Most, if not all, of the negative effects of the global economic downturn should be processed by the economy by the end of 2009. GDP is due to fall between 12% and 15% in 2009, then recover somewhat in 2010 and grow modestly in 2011. We believe however that the large hidden economy and solid base of household savings accumulated during the boom years should partly mitigate the consequences of this painful economic adjustment. That said, private consumption will most probably not commence its recovery until H2 2010 owing to a weak labor market and the lack of credit, while export-oriented sectors of the economy may begin to pick up as early as q4 2009, albeit primarily on account of devalued currency.

The risks to macroeconomic stability remain substantial. There are still uncertainties over the exchange rate, the ability of Ukraine to pay for own gas imports as well as provide a secure transit for gas to Europe, the effectiveness of the banks' recapitalization process and the future of the IMF program. Furthermore, the impending presidential campaign may impair effective policymaking and steer populist actions on the part of government, as has often been the case in the past. Nevertheless, those policy initiatives that have been put forward by Ukraine's creditors should improve the country's standing in the long-run.

The initiatives include containing pension expenditure, which is currently among the highest in the world, taking genuine steps to increase the independence of the National Bank, countering VAT fraud, implementing a flexible exchange rate regime, stimulating energy savings by bringing prices to economically justified levels, and others. We believe there is a good chance for Ukraine to finally push through these serious structural reforms, as they are not only being dictated by challenging external conditions, but are also being firmly pressed for by the international community.

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