



Macroeconomic Forecast Ukraine

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- The real GDP growth is estimated at 6.9% yoy in 2008 backed by strong real private final consumption expanding. At the same time, capital accumulation is estimated to grow moderately during the entire 2008.
- In 2009 the real GDP growth is expected to decelerate to 6.3% yoy, mainly due to significant slowdown in final consumption of households. Investment activity is forecast to speed up in 2009, partially thanks intensification of preparation to the European Football Championship in 2012.
- Lower final domestic demand is expected to cause a slowdown in growth of real imports in 2009. Though, net exports will remain negative as imports of goods and services still develop much faster than exports, against the background of misbalance between domestic demand and supply.
- High inflation is the major risk for economic development in 2008 and 2009 as it hurts purchasing power and endangers overall macroeconomic stability in the country. Another risk is related to the international financial market turmoil, which will result in deceleration of the net inflow of foreign capital into banking sector, adversely affecting the part of investments and consumption financed through bank credits. Moreover, political turbulence poses an additional burden on the economy, negatively affecting investment activity in the country.
- The consolidated fiscal revenues are estimated at UAH 311.5 bn (30.8% of GDP) in 2008, which is by UAH 30.0 bn higher comparing to Government fiscal plan approved in December 2007. The difference is attributed to other than built into the budget macroeconomic parameters, in particular inflation and nominal GDP. The IER expects that the Verkhovna Rada will approve amendments to the State Budget Law. As a result, the consolidated fiscal expenditures will be increased to UAH 326.6 bn, while the consolidated fiscal deficit will reach 1.5% of GDP.
- The consolidated fiscal revenues are expected to constitute UAH 394.1 bn or 30.5% of GDP in 2009, while the consolidated fiscal deficit is forecast at 1.9% of GDP. The deficit is likely to be financed at the expense of borrowings and privatisation receipts. Fulfillment of privatisation plan will remain one of the major fiscal risks. We expect that the share of capital fiscal expenditures in total consolidated expenditures will increase due to the necessity to finance infrastructure projects required for the preparation for the EURO-2012.
- The present trend for the widening of the current account deficit in Ukraine is expected to be maintained both this and next year. It is estimated that the deficit will reach USD 12.5 bn or 6.2% of GDP this year, and further expand to USD 17.6% or 6.5% of GDP next year.
- It is estimated that exports of goods will increase by 29.0% yoy in dollar terms in 2008, while commodity imports is forecast to grow by 38.0% yoy in dollar terms. In 2009 we expect some deceleration of imports growth primarily due to slowdown in domestic demand, although the rate will be still higher than the growth rate of exports. Thus, the deficit in trade in goods will continue to broaden.
- Money supply growth will decelerate slightly to 47% yoy in 2008 and further to 28% yoy in 2009. This development will be supported by further deceleration in foreign currency deposits and slower, but still strong growth in national currency time and savings deposits.
- The consumer price inflation is forecast to reach 26.0% on average in 2008 and somewhat decelerate to 16.0% in 2009.

Forecast Period:

Years 2008 and 2009

Forecast Variables:

The Macroeconomic forecast Ukraine is comprised of four blocks:

1) Gross domestic product

- GDP and its components

2) Fiscal indicators

- Consolidated fiscal revenues by sources
- Consolidated fiscal expenditures
- Consolidated fiscal deficit

3) Balance of payments

- Components of current account
- Components of capital and financial account

4) Monetary survey and inflation

- Monetary indicators
- Consumer inflation

Key forecast figures

	2007	2008E	2009F
Real GDP, %	7.6	6.9	6.3
Consolidated fiscal revenues, UAH bn	219.9	311.5	394.1
Consolidated fiscal deficit, % of GDP	1.1	1.5	1.9
Current account balance, % of GDP	-4.2	-6.1	-6.5
Net FDI inflow, USD bn	9.2	8.0	10.1
Money supply, UAH bn	391.3	576.1	735.7
CPI, % aop	12.8	26.0	16.0

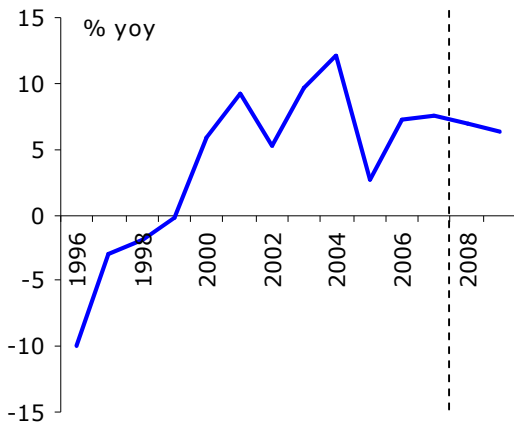
E - estimate, F - forecast

Source: Derzhkomstat, NBU, State Treasury, IER calculations and forecast

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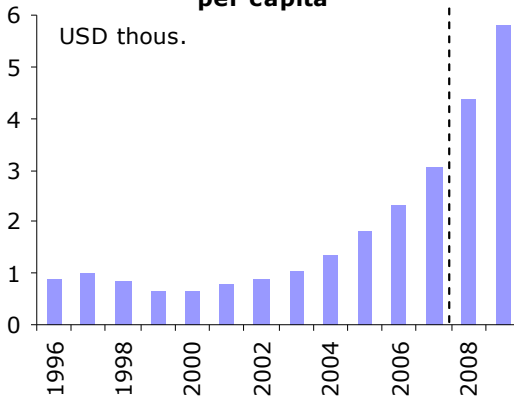


Gross Domestic Product



Source: Derzhkomstat, IER calculations

Gross Domestic Product per capita



Source: Derzhkomstat, IER calculations

GROSS DOMESTIC PRODUCT

GDP: Deceleration is expected in 2009

According to the Derzhkomstat, in the first five months of 2008 real GDP increased by 6.4% yoy, gradually accelerating since the beginning of the year. It is expected that the acceleration will continue in the second half of the year, and the real GDP growth reaches 6.9% yoy in 2008.

The real GDP growth is primarily based on still strong real private final consumption expanding thanks to increasing incomes, including social transfers, and limited saving opportunities within the country. At the same time, the expected acceleration of investments did not realise in the first quarter of the year, and capital accumulation is estimated to grow moderately during the entire 2008. The net exports will remain negative as imports of goods and services develop much faster than exports against the background of misbalance between domestic demand and supply.

There are several key risks for the economic development in 2008. The major risk is high inflation that hurts purchasing power and endangers overall macroeconomic stability in the country. In the first half of the year the inflationary pressure seems to contribute little to the slowdown of private consumption. Though, tougher monetary policy and gradual slowdown of real income growth are shifting the mood of households, likely resulting in noticeable decelerating of final consumption growth in the end of 2008 and in 2009. Growing energy prices also contribute to inflationary pressures raising costs of transport and utilities.

International financial market turmoil reduced the appetite for risk in the world, thereby making external borrowings more expensive. As a result, the net inflow of foreign capital into banking sector is expected to decelerate, adversely affecting the part of investments and consumption financed through bank credits.

Moreover, political uncertainty fuelled by the conflicts between the President and the Prime-Minister, and within the coalition poses additional burden on the economy, negatively affecting investment activity in the country.

In 2009 the real GDP growth is expected to decelerate to 6.3% yoy, mainly due to significant slowdown in final consumption of households. Lower final domestic demand is expected to cause the slowdown in growth of real imports, although it will still surpass export growth. Investment activity is forecast to speed up in 2009, partially thanks to large infrastructure projects expected to be launched next year to get Ukraine ready for the European Football Championship in 2012 (EURO-2012).

As in 2008, inflationary pressure – including expected next round of imported gas price increase – will remain among the key risks for the stable economic development of the country. Also, widening current account balance makes the country much more vulnerable to external price shocks. If current price trends on metal or chemical markets reverse and/or foreign capital inflows slow, Ukraine will face a strong depreciation pressure.

Private consumption: Households' consumption continue expanding

The final consumption of households has been the engine of the economic growth for several years already, and this situation is expected to sustain in 2008. The households' final consumption growth is forecast at 14.2% yoy in real terms in 2008, which is somewhat lower than in the previous year. The deceleration is attributed to a number of factors. First, the household income growth is expected to slow in real terms, as inflation 'eats up' a part of nominal increase limiting purchasing power of population. Though, wages and incomes are still expected to grow in real terms taking into account planned introduction of the third stage of the Unified Tariff Scale planned for September 2008 boosting wages in

Contributions to real GDP growth, demand side view

Expressed as percentage points of GDP growth

	2007	2008E	2009F
Real GDP	7.6	6.9	6.3
<i>Contributions:</i>			
Private consumption	10.0	8.4	4.1
Government consumption	0.5	0.5	0.5
Investments	5.5	3.5	4.2
Net exports	-8.4	-6.5	-2.5

E - estimate, F - forecast

Source: Derzhkomstat, IER calculations



public sector, and gradual increase in minimum wages exerting upward pressure on all wages in the economy.

Yet other factor for the deceleration of private consumption is a noticeable slowdown of households' credits that has fuelled the growth of consumption for the several years. According to the NBU, in June 2008 total credits to households increased by 78.9% yoy compared to 119.1% yoy a year before. The slowdown in borrowing could be attributed to increased interest rates due to tougher liquidity on domestic and external markets.

Still, despite high inflationary pressures consumption is expected to show above-trend growth, partially due to limited saving opportunities in the country. The negative real interest rates on deposits, falling stock market, depreciating US dollar, and stagnant prices on housing market fairly exhaust potentials for profitable low-risk savings. As a result, a lot of households prefer purchasing durable goods as an alternative to investments, thereby maintaining high growth rates of consumption. It should be noted that the majority of durable goods are imported.

The deceleration of private final consumption is forecast to aggravate next year. It will be mostly due to continued slowdown in incomes and less borrowings due to still high interest rates. Moreover, re-financing of existing loans will be more difficult, exerting additional pressure on households. These factors are expected to be partly counter-balanced by the equalising minimum wages and subsistence minimum, which would considerably boost minimum wages in 2009 and thus press wages upwards economy-wide. As a result, we forecast that the real households' final consumption will increase by 6.8% yoy in 2009.

Government consumption: State consumption will continue to grow moderately

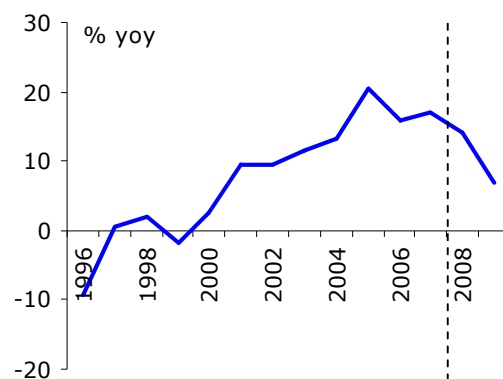
The contribution of the state final consumption into the real GDP growth is expected to remain moderate over next two years, continuing the trend established since 2005. In particular, the real state consumption is expected to increase by 2.9% yoy in 2008 and by 2.8% yoy in 2009. The forecast is derived from the estimates of the expenditures of the consolidated budget, assuming that there would be no significant expansion of the real expenditures on healthcare and education, the largest part of state consumption bundle. Instead, it is expected that the Government spending will be oriented to the execution of social transfers and on infrastructure development associated with the preparations for the EURO-2012.

Investment: After slowdown in 2008, investment activity is expected to somewhat recover next year

Contrary to expectations, investment activity in Ukraine noticeably decelerated in the first quarter of 2008, though against the high statistical base of the previous year. The deceleration of investment activity is reflected in the cessation of growth in construction. According to the Derzhkomstat, between January and March investments in fixed assets increased by 10.4% yoy compared to 32.2% yoy growth a year ago. This slowdown is largely attributed to lower manufacturing investments that account for more than a quarter of total investments and the growth rates of which reduced to 2.0% yoy in the first quarter of 2008 from 54.8% yoy a year ago. While increased competition and need to introduce energy-saving technologies against the background of growing oil and gas prices remain the key push factors for investments, the deceleration could be explained by sustained political uncertainty, mounting inflationary pressures, and more costly financing both on domestic and external markets. As these factors are expected to remain in effect over the year, the investment growth is forecast to be moderate, and the real gross fixed capital accumulation growth will be 12.6% yoy in 2008.

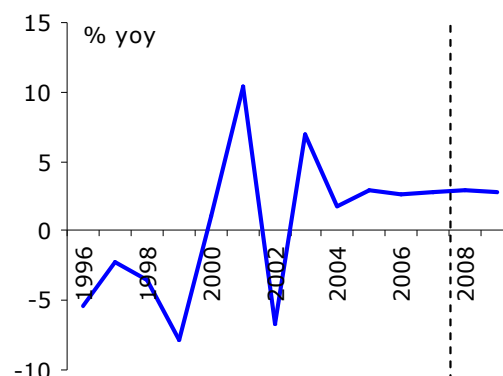
Though, we forecast an acceleration of investment activity in 2009. The speeding-up will be associated with intensified preparations for the EURO-2012. In particular, more of state capital expenditures

Households' Final Consumption



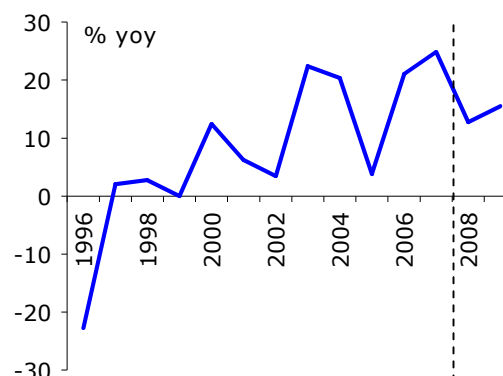
Source: Derzhkomstat, IER calculations

Government Final Consumption



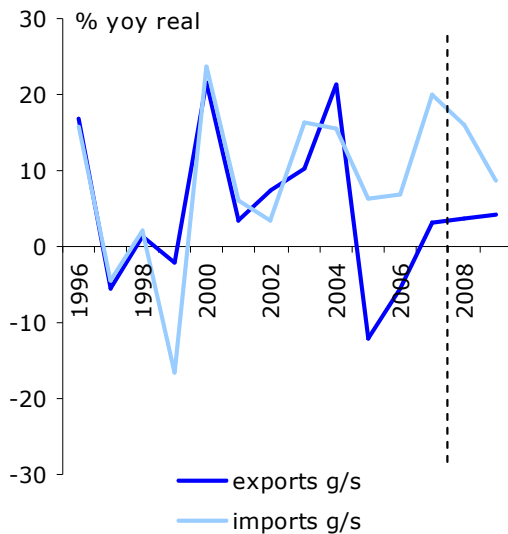
Source: Derzhkomstat, IER calculations

Gross Fixed Capital Accumulation



Source: Derzhkomstat, IER calculations

Exports and Imports



Source: Derzhkomstat, IER calculations

are expected to be devoted to infrastructure projects, and also the state will provide large-scale budget guarantees for private investments. As a result, the real gross fixed capital accumulation is estimated to increase by 15.4% yoy in 2009.

External sector: Imports will continue growing faster than exports

Strong domestic demand – first of all on consumer durables – was behind the widening gap between growth rates of imports and exports in real terms. In particular, it is estimated that in 2008 real exports of goods and services will increase by 3.7% yoy, only slightly accelerating compared to the previous year partially thanks to the loosening of quantitative trade restrictions after Ukraine joined the WTO in May 2008. At the same time, real imports of goods and services are expected to grow by 16.0% yoy in 2008, driven by still strong expansion of households' consumption.

The deceleration of private consumption growth and further increase in energy prices – especially the price for imported gas – are expected to slow the real import's expansion in 2009. Real imports are forecast to grow by 8.8% yoy. Real exports are estimated to increase by 4.2% yoy backed by an increase in agricultural exports due to a high harvest in the 2008/2009 marketing year, the maintenance of high demand for machinery building products in CIS countries, and still favourable world conjuncture on metal and chemical markets.

Production: Manufacturing and trade will remain the key drivers of GDP growth on production side

In 2008 the value added in *agriculture* is expected to increase by 8.2% yoy in real terms thanks to good grain harvest and against the background of the drop in production last year. Next year the value added in the sector will grow at 5.1%, mainly due to statistical base effect assuming normal weather conditions. Despite the acceleration of investments in the sector, no drastic changes in productivity spurring production over the trend is projected in short-term horizon.

Manufacturing has remained one of the key driving forces for real GDP growth on production side alongside with trade. Here, the machine building is expected to lead the growth against the background of strong domestic and the CIS countries' demand for machines and equipments both for consumption and investment needs. Other important contributor to the growth is metal production as the high world prices on metals allow compensating increase in prices for sector key inputs – ores and gas. It is expected that value added in manufacturing will increase by 9.0% yoy in 2008, and by slightly lower 8.2% yoy in 2009. The moderation is attributed to surging prices for inputs and deceleration of domestic demand.

The deceleration of investment activity observed in 2008 is reflected in the cessation of growth in *construction*. According to the Derzhkomstat, in the first five months of the year the value added in the sector dropped by 3.8% yoy, attributed to the decline of both construction activities and preparations of new plots for construction. We forecast that the current situation will be preserved till the end of the year, and the annual rate of contraction is forecast at 3.0% yoy. Though, the sector is expected to recover in 2009 thanks to spur of investments in infrastructure associated with the preparation for the EURO-2012. Against the background of reduced statistical base of the year 2008, next year the valued added in construction is expected to increase by 15.6% yoy.

Services will continue to maintain high growth rates in 2008 backed by the still rather strong domestic demand. Trade shows the highest rates of growth: it is estimated to increase by 15.1% in real terms in 2008, thus to the large extent preserving the growth rates observed in the first half of the year. Though, the sector real growth is expected to somewhat decelerate to 12.5% next year due to slowdown in domestic demand.

Contributions to real GDP growth, supply side view

Expressed as percentage points of GDP growth

	2007	2008E	2009F
Real GDP	7.6	6.9	6.3
<i>Contributions:</i>			
Agriculture	-0.4	0.5	0.4
Extractive industry	0.2	0.2	0.2
Manufacturing	2.6	1.8	1.7
Production and distribution of electricity, gas and water	0.0	0.1	0.1
Construction	0.5	-0.1	0.6
Trade, repair services	2.6	1.9	1.5
Transport	1.1	0.8	0.7
Education	0.2	0.1	0.0
Health care	0.0	0.0	0.0
Other types of economic activity	1.2	1.7	1.3
Estimated payments to financial intermediaries	-0.7	-0.9	-1.1
Net taxes on products	0.3	0.8	0.8

E - estimate, F - forecast

Source: Derzhkomstat, IER calculations

FISCAL INDICATORS

Consolidated fiscal revenues: Fiscal revenues will be over-executed in 2008

In 2007 consolidated fiscal revenues amounted to UAH 219.9 bn or 30.8% of GDP, over-executed by 0.8% of the projected level thanks to higher than officially forecast inflation that drove tax revenues up. The over-execution of fiscal revenues because of higher macroeconomic figures than those foreseen in the budget has been usual for Ukraine during the last four years.

For 2008 the IER forecasts the consolidated fiscal revenues at UAH 311.5 bn (or 30.8% of GDP), which is by UAH 30.0 bn higher comparing to Government fiscal plan approved in December 2007. The share of the GDP distributed through consolidated budget will remain at the level of 2007.

The consolidated fiscal revenues are expected to constitute UAH 394.1 bn or 30.5% of GDP in 2009. The slight reduction of share of the GDP distributed through budget is primarily attributed to lower shares of revenues received from the VAT, taxes on international trade and other tax revenues.

EPT: High inflation boosts collection of enterprise profit tax

Enterprise profits tax (EPT) is one of the major sources of consolidated fiscal revenues. In 2007 EPT revenues amounted to UAH 34.4 bn being over-executed by 18.6% of plan approved as result of amendments to the State budget in June, 2007.

During the first five months of 2008 the EPT revenues amounted to UAH 16.0 bn, exceeding the target by 12.7%. Such over-execution can be explained by a surge in profits due to favourable price situation on world commodities market. As a result, the Government forecast underestimated actual enterprises' profits, resulting in higher than projected revenues from EPT.

The Institute estimates EPT revenues for 2008 at UAH 49.6 bn (4.9% of GDP), which is by UAH 6.8 bn higher than the Government plan set in December 2007. The over-execution of EPT collections is likely to be mainly attributed to stronger than officially projected inflation in Ukraine, which along with the further growth of prices for Ukrainian products at external markets contributes to higher profitability of enterprises.

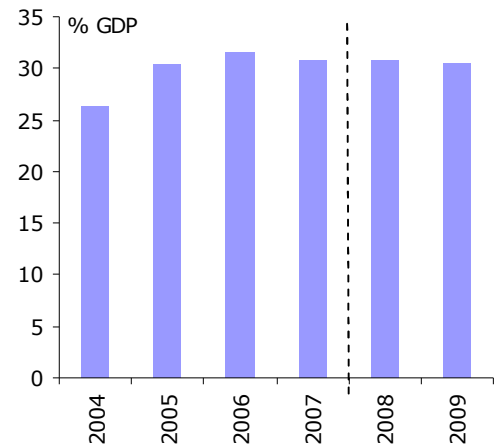
The EPT revenues for 2009 are forecast at UAH 63.9 bn or 5.0% of GDP. The enterprises are expected to face significant costs pressure from prices on inputs like natural gas and labour force, though high prices for metal and chemical products at world market are assumed to compensate these pressures supporting companies. Thus, it is projected that the enterprises will be able to keep profitability margins at the 2007 or 2008 level. While forecasting the EPT collections we assume no major changes in the EPT legislation due to continuation of political crisis and inability of the Parliament to approve a new Tax Code.

The risks for the EPT forecast for 2008 and 2009 are comprised with other than projected economic development. An additional risk is related to possible changes in the EPT legislation, including the change in tax rate and restoration or introduction of tax privileges.

VAT: Revenues in 2008 are estimated to reach UAH 98.7 bn

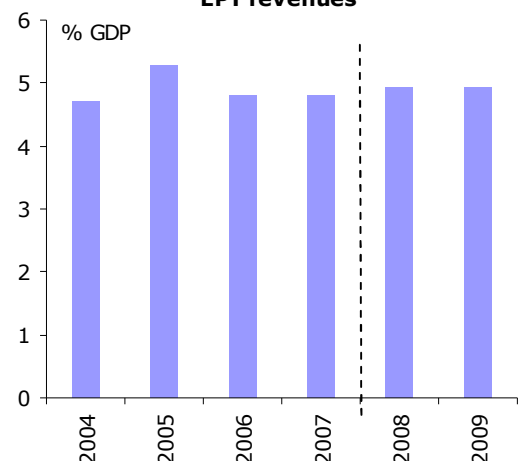
The value added tax (VAT) remains the largest tax source of the consolidated fiscal revenues, accounting for around 30% of total revenues. In 2007 the VAT collection was UAH 59.4 bn (8.3% of GDP), which was 8.8% lower than the fiscal plan. The under-execution was partially attributed to the provision of tax credit to the National JSC 'Naftogaz Ukraine', starting from July 2007. At the same time, during 2007 the VAT refund arrears – both current and overdue – increased by UAH 1.7 bn to UAH 8.5 bn.

Consolidated fiscal revenues

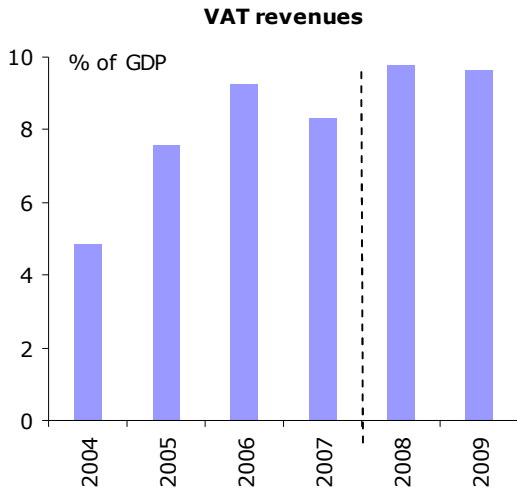


Source: State Treasury Reports, IER calculations

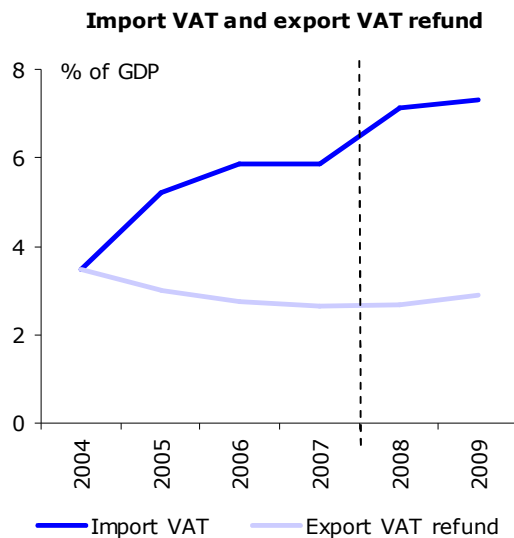
EPT revenues



Source: State Treasury Reports, IER calculations



Source: State Treasury Reports, IER calculations



Source: State Treasury Reports, IER calculations

Between January and May 2008 the VAT revenues amounted to UAH 36.3 bn, being by 12.7% above the target. The execution rate of the VAT revenues from imports was 41.8% higher than projected, while the collection of VAT levied on domestically produced goods was 3.7% below the planned figure. The additional receipts from VAT on imports were obtained due to surge in import prices as well as the prohibition of tax bills circulation and resumption of anti-smuggling activity. At the same time, the Government over-fulfilled the plan of VAT refunds by UAH 4.6 bn or 50.5%.

The IER estimates the VAT revenues at UAH 98.7 bn in 2008. The share VAT revenues in GDP will reach 9.8% as compared to 8.3% in 2007. The share in crease is associated with the continuation of the macroeconomic trends of 2007 including dominance of the imports over the exports and favourable consumption outlook. Besides, it is assumed that privileges for the special economic zones will not be restored during the year. According to our estimate, the Government fiscal plan set in December 2007 is expected to be over-executed in 2008 by 12.6% mainly due to higher than forecast macroeconomic parameters.

The VAT revenues for 2009 are forecast to reach UAH 125.0 bn or 9.7% of GDP. The driving force of revenue rise will be further growth of domestic consumption and continued dominance of imports in foreign trade. Also, we assume the introduction of the 20% VAT rate in the agricultural sector, replacing the present 0% VAT rate. Additionally, we suppose that the measures taken before to enhance VAT administration will be strengthened in 2009.

The major risks of the VAT revenue forecasts for 2008 and 2009 are related to unexpected changes in macroeconomic parameters. Besides, there is a risk associated with the possible changes in the legislation, including resumption of tax bills circulation, the introduction of VAT privileges in special economic zones and provision of tax credit for Government enterprises. Finally, there is a risk of further accumulation of VAT refund arrears that would increase fiscal liabilities in future periods.

PIT: The Government underestimates the PIT revenues by UAH 3.8 bn in 2008

The personal income tax (PIT) remains one of the major revenue sources of consolidated tax revenues. The PIT collections in 2007 reached UAH 34.8 bn (4.9% of GDP) surpassing adjusted Government plan by 4.2%. The major engine of the PIT collections was gradual increase in the minimum wage that pushed all wages upwards. In 2007 the PIT brought around 59.6% of local budget revenues (not accounting for transfers) and was streamlined for financing delegated responsibilities of local Government, primarily health care and education.

The IER forecasts the PIT revenues for 2008 at UAH 49.3 bn (4.9% of GDP). The revenues growth is related to higher minimum wage as well as inflation, which pushes wage increases in all sectors of economy. Besides, the introduction of the second stage of the Unified Tariff Scale in the public sector in the end of 2007 and the planned introduction of its third stage also contribute to a higher wage bill. Our previous forecast was revised upwards as the Government increased the minimum wage at a higher pace than it was previously assumed and inflation is also higher than expected, which pushes gross wages and nominal GDP up. The PIT revenue forecast for 2008 is UAH 3.8 bn higher than planned by the Government in December 2007.

The PIT revenue forecast for 2009 is UAH 64.9 or 5.0% of GDP. We expect that gross wages will continue growing, though at a lower pace than in previous years. The legislation basis is assumed to remain stable, as it is not likely that the Tax Code will be approved in time for being introduced in 2009. The minimum wage growth as well as economic development will be the major factors for gross wage growth.

Parameters of PIT forecast:

	2007	2008E	2009F
PIT rate, %	15	15	15
Gross wages, UAH bn	210	290	375
Minimum wage at the beginning of the year, UAH	400	515	700
Subsistence minimum for persons able to work at the beginning of the year, UAH	525	633	700
Social Privilege, UAH	200	258	350

E - estimate, F - forecast

Source: legislation of Ukraine, IER estimates

The risks inherent in the PIT revenue forecasts for 2008 and 2009 are associated with lower than assumed wage growth. In addition, the forecast could be challenged if the Government introduces further increases of minimum wage and subsistence minimum.

Taxes on international trade: Lower import duties will be overcompensated by increased imports

During the last four years the share of taxes on international trade in the consolidated fiscal revenues was near 4.5%, from which around 95% was received from import duties. In 2007 the revenues from taxes on international trade amounted to UAH 10.0 bn (1.4% in GDP), which was 8.3% higher than the respective fiscal plan due to higher than officially projected import growth. During the first five months of 2008 this revenue item was over-executed by 30.7% of target in line with strong growth of imports.

The Ukraine's membership in the WTO entails the reduction and binding of import and export tariffs as well as the elimination of quantitative export restrictions and the liberalization of trade in services. Though, we expect that the downward pressure on revenues from taxes on international trade due to this fact will be counterbalanced by acceleration of foreign trade. Besides, we forecast increase in nominal imports in the second half of 2008 and further in 2009 due to high import prices, growing domestic consumption and resumption of anti-smuggling activity of the Government. As a result, we do not forecast significant reduction of share of revenues from taxes on international trade collections in GDP in 2008 and 2009. In nominal terms the revenues from these taxes will grow to UAH 14.2 bn and UAH 16.6 bn in next two years respectively. Though, their contribution to the consolidated fiscal revenues will slightly decline as compared to 2007 (to 4.6% and 4.2% in 2008 and 2009, respectively).

The major risks of the revenues from taxes on international trade for 2008 and 2009 are related to other than expected domestic demand for imported consumption and investment goods.

Other tax revenues: Slightly decreasing as share of GDP for the next two years

Other tax revenues include property taxes, tax on use of natural resources, excises, licenses and patents charges, local taxes (other than PIT) and charges and a couple of smaller taxes. The share of other tax revenues in consolidated fiscal revenues was gradually decreasing from 14.9% (or 4.2% of GDP) in 2003 to 10.3% (or 3.2% of GDP) in 2007. The main reason of this decline is rigid tax base for such taxes.

According to our estimates the downtrend for share of other tax revenues in consolidated budget revenues will be maintained during the forecasting horizon. In the next two years we do not expect significant changes in rates and tax base for local taxes and charges, taxes on property, excises, and taxes for natural resources use, which are the major sources of other tax revenues. As a result, the total amount of other tax revenues is forecasted at UAH 29.0 bn (2.9% of GDP) in 2008 and UAH 33.1 bn (2.6% of GDP) in 2009.

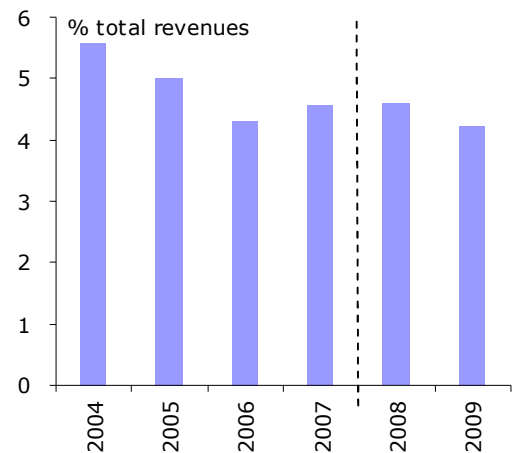
The major risk for other tax revenues collection in 2008-2009 is adoption of changes of legislation that regulates taxation regimes for abovementioned taxes.

Other revenues: The Institute forecasts other revenues in average at 7.0% of GDP in 2008 and 2009

The other revenues are important source of consolidated fiscal revenues with the stable share at around 27.0% during the last three years. Major sources of other revenues are rent payments, the income from state enterprises (share of net income and dividend payments) due to the state coffer, administrative charges and fines. In 2007 the other revenues totalled UAH 58.7 bn (8.2% of GDP).

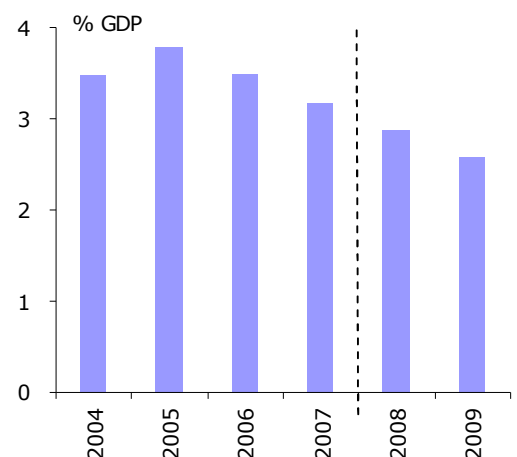
We expect the gradual reduction of other revenues share in consolidated fiscal revenues in 2008 (up to 7.0% of GDP) due to our

Taxes on international trade

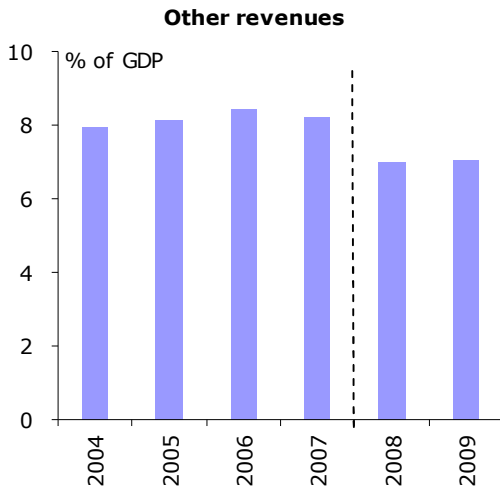


Source: State Treasury Reports, IER calculations

Other tax revenues



Source: State Treasury Reports, IER calculations



Source: State Treasury Reports, IER calculations

assumption of the absence of any significant changes in land laws that regulate issues of state lands rent and sales. Besides, we assume lower profits of the state-owned enterprises due to higher input costs, problems with hiring qualified management, and administrative measures faced by these enterprises. As a result, we forecast the contribution to consolidated fiscal revenues from other revenues at UAH 70.7 bn and UAH 90.5 bn in 2008 and 2009, respectively.

The key risk of forecast of other revenues in 2008 and 2009 is related to unexpected changes in land laws that can challenge the Government plans for revenues from state lands rent and sales. The other risk is comprised with less than expected profits of state enterprises caused by the unpredictable change of price of inputs and changes in price regulation concerning the output of state companies.

Consolidated fiscal expenditures: Expenditures in 2008 are estimated to reach UAH 326.6 bn

In 2007 the consolidated fiscal expenditures were traditionally under-executed (by 5.7% of plan) with higher execution rate of financing current expenditures. Execution of capital expenditures improved by the end of year, but still they were financed at low 89.1% of target.

For 2008 the Government underestimated consolidated fiscal revenues. As a result, we expect that in early September the amendments to the State Budget Law will be approved. Consequently, the Institute estimates the consolidated fiscal expenditures at UAH 326.6 bn in 2008. The expenditures share in GDP will comprise 32.1%, which is higher than in 2007 due to rapid increase of wages and current transfers and subsidies associated with high inflation rate. This forecast is higher than official plan approved in December 2007 (by 9.4% of plan) due to higher than previously planned fiscal revenues.

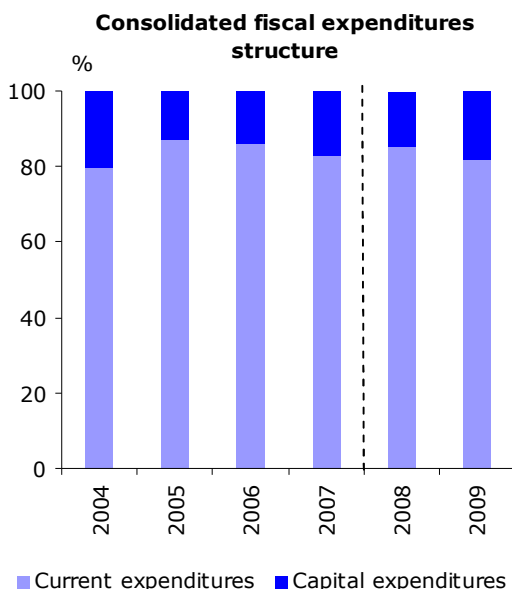
The forecast of consolidated fiscal expenditures for 2009 takes into account the increased capital expenditures necessitated by the preparation to the EURO-2012. Therefore, the share of capital expenditures in total expenditures will increase and reach 18.2% as compared to expected 14.7% in 2008. At the same time, we expect certain reduction of share of current transfers and subsidies as we assume introduction of some steps towards target provision of social assistance. The share of total consolidated fiscal expenditures is forecast to slightly increase to 32.2% of GDP in 2009.

The risk inherent in forecast of consolidated fiscal expenditures is associated primarily with higher than we assume growth of current expenditures, in particular, wages and current transfers and subsidies in 2008 and 2009. Another risk is associated with under-execution of capital expenditures.

Consolidated fiscal deficit: The deficit will be at 1.5% of GDP in 2008

If the Verkhovna Rada fails to approve State Budget Law amendments, it is likely that the consolidated fiscal surplus will be at UAH 13.0 bn or 1.3% of GDP.

However, under the assumption that the amendments are approved the IER estimates the consolidated fiscal deficit at UAH 15.2 bn or 1.5% of GDP in 2008, which is by UAH 2.3 bn lower than officially projected in December 2007. The major reason for that is higher than planned fiscal revenues. The deficit will be primarily financed at the expense of borrowings (UAH 10 bn). We assume that the Government plan for both domestic and external borrowings will be fulfilled (at UAH 4.2 bn and UAH 5.1 bn, respectively). At the same time, the Government will fail to realise the privatisation plan. According to our estimates, the privatisation receipts will amount to UAH 0.7 bn as compared to officially projected UAH 8.9 bn. We assume that the rest of deficit will be financed at the expense of funds accumulated on the Unified Treasury account.

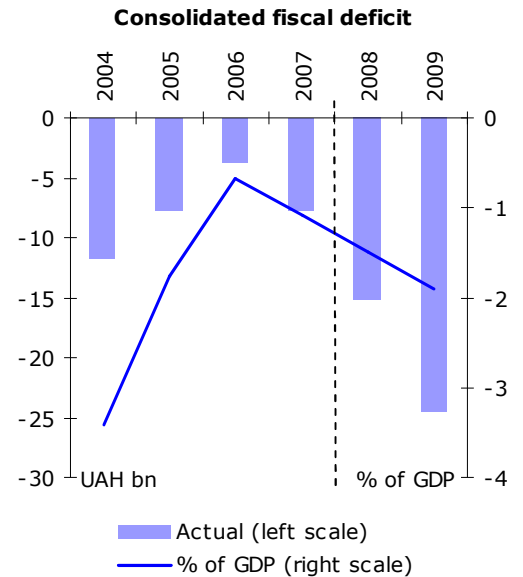


Source: State Treasury Reports, IER calculations



The Institute forecasts further increase of consolidated budget deficit in 2009 that will reach UAH 24.6 bn or 1.9% of GDP. The higher deficit is associated with our assumption on increase in capital expenditures due to the preparation to the EURO-2012. According to our forecast, the borrowings will remain the major source of deficit financing. At the same time, there will be a shift from external to domestic borrowings (UAH 5.5 bn and UAH 8.6 bn, respectively). We believe that the Government will be able to sell several large state corporations. This allows us to forecast the privatisation receipts at UAH 10.0 bn in 2009.

The risks for the fiscal deficit forecast for 2008 and 2009 are comprised with different macroeconomic stability shocks, which may force the Government to increase the deficit to finance the fiscal expenditures. An additional risk is related to amendments of fiscal expenditure dictated by the political situation. On the financing side, the fulfilment of the privatisation plan remains one of the essential fiscal risks. Besides, there is the risk of worsening of borrowing conditions on the external debt market. Yet other risk might be associated with failure of Government attempts to increase the borrowings on domestic market.



Source: State Treasury Reports, IER calculations

BALANCE OF PAYMENTS

Current account: The current account deficit is forecast to further widen during 2008-2009

We expect that the present trend for the widening of the current account deficit in Ukraine will be maintained both this and next year. According to the NBU, in the first quarter of 2008 the current account deficit was USD 3.6 bn, mainly due to surge in commodity imports. It is estimated that the deficit will reach USD 12.5 bn or 6.2% of GDP, and further expand to USD 17.6% or 6.5% of GDP next year.

The membership in the WTO since May 16, 2008 brought important changes in Ukraine's trade regime, stimulating both exports and imports. For exports, the key changes were the elimination of import quotas on metals established by the EU, export quotas on selected agricultural products set by Ukraine, as well as gradual reduction of export duties. For imports, the reduction and binding of Ukrainian tariffs was important, especially for agro-food products and automotive industry. Further adjustment to international standards is expected to facilitate trade over the medium-term horizon.

It is estimated that exports of goods will increase by 29.0% yoy in dollar terms in 2008. Thus they maintain the path observed at the beginning of the year as the stimulating impact of the WTO membership and high world prices on metals, chemicals and agricultural products will be balanced out by growing prices for inputs and appreciation of hryvnia. Commodity imports are forecast to grow by 38.0% yoy in dollar terms driven by the reduction in tariff barriers, higher prices, especially for energy materials, and strong internal demand. As a result, the deficit in commodity trade will widen to USD 19.1 bn in 2008, driving the current account deficit.

In 2009 we expect some deceleration of imports growth primarily due to slowdown in domestic demand, although the rate will be still higher than the growth rate of exports. In particular, commodity exports are forecast to increase by 28.0% yoy in dollar terms, while imports will grow by 30.0% yoy in dollar terms. Thus, the deficit in trade in goods will continue to broaden to USD 26.1 bn in 2009.

As before, the deficit in commodity trade will be partially compensated by the positive balance in service trade and inflow of current transfers, including remittances. In particular, it is expected that service exports will increase by 36.0% yoy in 2008 and by 32.0% in 2009 driven by recovery of transportation services, especially pipeline transit services, acceleration of business-related services and tourism. Imports of services are forecast to grow by 33.0% yoy in 2008 and 31.0% yoy next year, dominated by the expansion of business-related services. As a result, the service trade balance will reach USD 4.0 bn in 2008 and USD 5.4 bn in 2009.

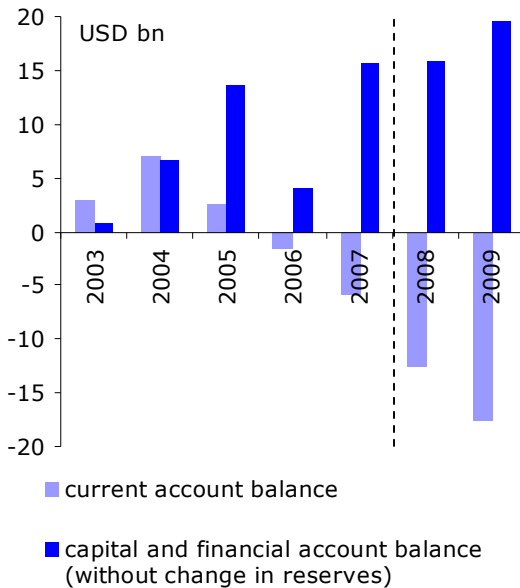
Current transfers are forecast to maintain upward trend, although their growth rate will gradually decelerate due to slowdown in remittances from the developed countries experiencing an economic downturn. Thus, current transfers are expected to reach USD 5.0 bn and USD 5.9 bn in 2008 and 2009, respectively. At the same time, we forecast the continuation of outflow of incomes at USD 2.4 bn and USD 2.8 bn during current and next years, respectively.

The risk of the current account deficit development are mostly for its widening, including the faster than projected growth in imports both for goods and services, the sharp deceleration of current account transfers, and higher than project income outflows.

Capital and financial accounts: The inflow of foreign capital is expected to stay high

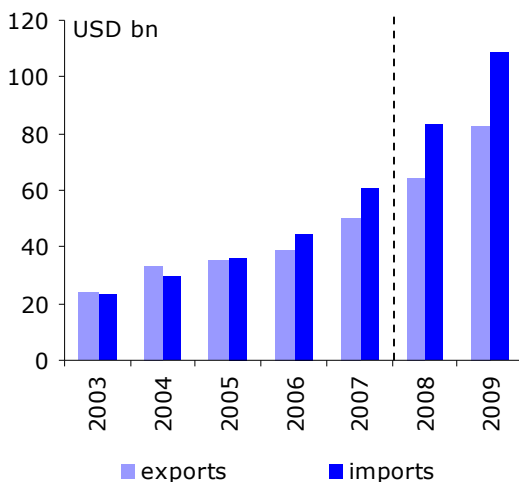
As in 2007, the foreign capital inflows are expected to sufficiently cover the wide current account deficit during 2008-2009, thus

Balance of payments



Source: NBU, IER calculations

Commodity exports and imports



Source: NBU, IER calculations



preventing depreciation of the national currency despite the large current account deficit gap.

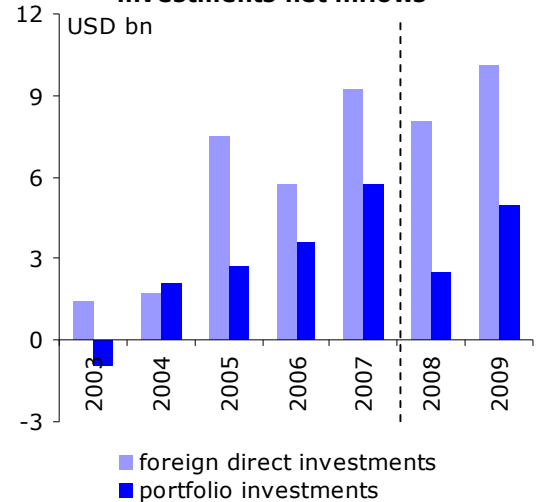
In particular, in 2008 capital inflows as measured by financial account surplus are expected to remain at level close to that of 2007 at USD 15.9 bn. That goes in line with the current stance of the account, as according to the NBU in the first quarter of 2008 the balance of capital and financial accounts reached USD 3.6 bn, continue accelerating in year-on-year terms.

The foreign direct investments inflows are expected to remain strong in 2008 at USD 8.0 bn, with financial sector remaining the key attractor of foreign capital. At the same time, portfolio investments will plunge to USD 2.5 bn due to unfavourable market conditions. Other investments are forecast to increase to USD 5.3 bn as slower external bank borrowing will be offset by strong real sector borrowing and decrease in capital outflows.

In 2009 financial account surplus is expected to reach USD 19.6 bn. Increase in capital inflows will be backed by sustained increase in the foreign direct investments inflow to USD 10.1 bn supported by privatization and infrastructure investment. We forecast the rebound in portfolio investment to USD 4.9 bn thanks to the improvement of world financial market conditions, also supporting the financial account balance.

The risks on the capital and financial account side stay mostly with less than expected foreign capital inflows either due to external shocks like one more round of financial crisis or considerable economic downturn in the developed countries, or due to domestic reasons like the acute political turbulence. If foreign capital inflows become insufficient to cover expanding current account deficit, Ukraine will face severe depreciation pressure.

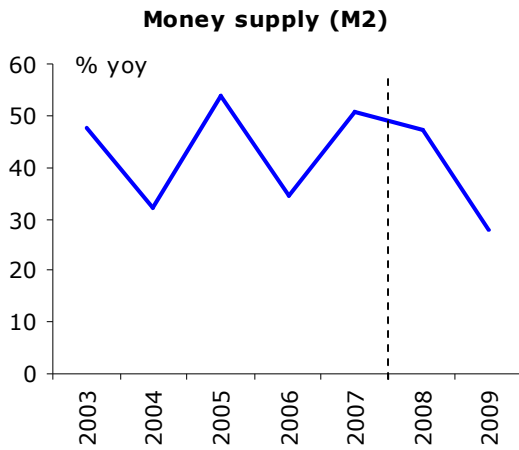
Foreign direct and portfolio investments net inflows



Source: NBU, IER calculations

MONETARY SURVEY AND INFLATION

Monetary survey: Money supply will decelerate during next two years

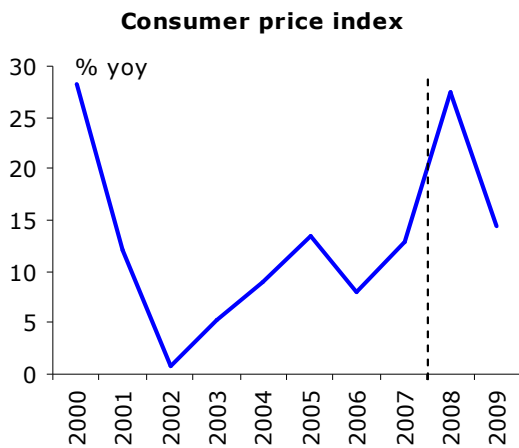


Source: NBU, IER calculations

We expect money supply (M2) growth to decelerate slightly to 47.2% yoy in 2008. In 2009 money supply will slow further to 27.7% yoy. This development will be supported by further deceleration in foreign currency deposits and slower, but still strong growth in national currency time and savings deposits as dollarisation will tend to decrease under increased exchange rate flexibility. Velocity of money will continue to decelerate in 2008 and 2009 but at significantly lower pace than in previous year as monetization of economy becomes close to saturation.

On the asset side domestic credit to private sector will be constrained by decrease in capital inflows to banking sector and tighter monetary policy. Claims of banks to private sector are forecast to grow at 55% and 33% yoy in 2008 and 2009, respectively, and will reach UAH 914 bn by the end of 2009.

Inflation: Consumer inflation will decelerate in 2009



Source: Derzhkomstat, IER calculations

According to the Derzhkomstat, in June the consumer prices increased by 29.3% yoy, though somewhat decelerating from the peak reached in May at 31.1% yoy. On the demand side the consumer inflation is driven by aggressive income policy, including further increases in minimum wages and pensions, stimulating strong consumer demand, and still high growth of monetary aggregates. On the supply side tight conditions on food market, growing utility tariffs due to growing price of imported gas and high external demand for food products coupled with limited domestic supply contribute to inflation growth. Although the inflation is expected to slowdown during the summer thanks to good harvest, the most of demand and supply pressures are expected to be maintained throughout the year. As a result, consumer price inflation in 2008 is forecast to reach 26.0% as annual average.

In 2009 we expect slower growth of monetary aggregates, softer market conditions on food market and Government administrative measures to cause deceleration in inflation. However, still high inflation expectations and further increase in imported gas price will support inflation pressure. Thus, we forecast consumer inflation to decelerate compared to the previous year, but still stay well above the ten-percentage threshold at 16.0% as annual average.



ASSUMPTIONS OF THE FORECAST

- Continued political turbulence will mean a standstill in structural reforms in 2008-2009.
- Elimination of quantitative barriers to trade and liberalisation of tariff regime due to Ukraine's WTO membership since May 16, 2008.
- Ukraine together with Poland will host the European Football Championship in 2012.
- In 2008 the imported gas price will be maintained USD 179.5 per thousand cubic meters at the border with Russia.
- Price for imported gas will reach the range of USD 310-340 per thousand cubic meters at the border with Russia in 2009.
- The world prices for metal, chemicals, and raw oil remain high and growing, although the growth will slow in 2009.
- Ukraine will not sign a FTA agreement with the EU within the period of forecast.
- The VAT rate at the level of 20% will be introduced in 2009 for the agricultural sector. Otherwise, the tax legislation, including tax rates, remains unchanged in 2008 and 2009.
- VAT and EPT privileges will not be introduced in 2008 and 2009.
- VAT refund arrears will not be accumulated in 2008 and 2009.
- The measures taken in 2007 to enhance VAT administration will be continued in 2008 and 2009.
- The minimum wage is expected to be raised to the level of subsistence minimum set for working able individuals on January 1, 2009.
- The wage distribution remains the same as in 2007.
- Employment pattern will not significantly change as compared to 2007.
- The anti-smuggling policy is to be continued by the Government in 2008 and 2009.
- Stable tax bases in 2008-2009 for taxes on property, taxes on use of natural resources, licenses and patents charges and local taxes and charges.
- No major changes in land laws concerning pricing for state land's rent and sales will be introduced in 2008 and 2009.
- The share of rent payments and other sources of revenues in consolidated budget are assumed the same as in 2007.
- The profitability of state enterprises will slightly decrease in 2008 and 2009.
- The official nominal exchange rate will be 4.95 UAH/USD in 2008 and UAH/USD 4.80 in 2009 with increased volatility within the official band.


Table 1. National Accounts (GDP)

		2005	2006	2007	2008E	2009F
Nominal GDP	UAH bn	441.5	537.7	712.9	1010.1	1293.4
Nominal GDP	USD bn	86.2	106.5	141.2	204.1	269.4
Real GDP	% yoy	2.7	7.3	7.6	6.9	6.3
GDP expenditure side components growth						
Private consumption	% yoy	20.6	15.9	17.1	14.2	6.8
State consumption	% yoy	2.9	2.7	2.8	2.9	2.8
Fixed assets accumulation	% yoy	3.9	21.2	24.8	12.6	15.4
Exports	% yoy	-12.2	-5.6	3.2	3.7	4.2
Imports	% yoy	6.4	6.8	19.9	16.0	8.8
GDP production side components growth						
Agriculture	% yoy	0.4	2.0	-5.0	8.2	5.1
Extractive industry	% yoy	2.5	9.9	4.1	4.0	4.8
Manufacturing	% yoy	0.4	9.2	12.8	9.0	8.2
Production and distribution of electricity, gas and water	% yoy	1.7	0.1	1.3	2.1	1.7
Construction	% yoy	-13.3	0.3	13.2	-3.0	15.6
Trade, repair services	% yoy	-14.7	17.7	20.6	15.1	12.5
Transport	% yoy	8.2	7.6	11.0	7.8	7.9
Education	% yoy	0.0	2.1	4.3	1.0	1.0
Health care	% yoy	0.2	2.4	-0.4	1.5	1.5
Other types of economic activity	% yoy	9.3	5.7	6.0	8.2	5.5
Estimated payments to financial intermediaries	% yoy					
		-0.5	-1.0	-0.7	-0.9	-1.1
Net taxes on products	% yoy	2.5	1.6	0.3	0.8	0.8

Table 2. Fiscal Indicators

		2005	2006	2007	2008E	2009F
Consolidated fiscal revenues	UAH bn	134.0	171.7	219.9	311.5	394.1
	% of GDP	30.4	31.6	30.8	30.8	30.6
EPT revenues	UAH bn	23.5	26.2	34.4	49.6	63.9
	% of GDP	5.3	4.8	4.8	4.9	5.0
VAT revenues	UAH bn	33.8	50.4	59.4	98.7	125.0
	% of GDP	7.7	9.3	8.3	9.8	9.7
PIT revenues	UAH bn	17.3	22.8	34.8	49.3	64.9
	% of GDP	3.9	4.2	4.9	4.9	5.0
Consolidated fiscal deficit	% of GDP	1.8	0.7	1.1	1.5	1.9
Privatisation receipts	UAH bn	7.4	3.8	2.2	0.7	10.0
State debt	% of GDP	17.7	15.0	12.4	9.9	9.0

Table 3. Balance of Payments

		2005	2006	2007	2008E	2009F
Current Account balance	USD bn	2.5	-1.6	-5.9	-12.5	-17.6
	% of GDP	2.9	-1.5	-4.2	-6.1	-6.5
Exports of goods	USD bn	35.0	38.9	49.8	64.3	82.3
Imports of goods	USD bn	-36.2	-44.1	-60.4	-83.4	-108.4
Balance of services	USD bn	1.8	2.1	2.7	4.0	5.4
Transfers net	USD bn	2.8	3.2	4.1	5.0	5.9
Income net	USD bn	-1.0	-1.7	-2.1	-2.4	-2.8
Capital and Financial Accounts	USD bn	13.8	3.9	15.8	15.8	19.6
Direct Investments	USD bn	7.5	5.7	9.2	8.0	10.1
Portfolio investments	USD bn	2.8	3.6	5.8	2.5	4.9
Other investments	USD bn	3.5	-5.4	0.8	5.3	4.5

Table 4. Monetary Aggregates and CPI

		2005	2006	2007	2008E	2009F
M0	UAH bn	60.2	75.0	111.1	157.8	205.1
	% yoy	42.2	24.5	48.2	42.0	30.0
M1	UAH bn	98.6	123.3	181.7	262.4	303.7
	% yoy	46.9	25.1	47.4	44.5	15.7
M2	UAH bn	193.1	259.4	391.3	576.1	735.7
	% yoy	53.9	34.3	50.8	47.2	27.7
CPI	% yoy aop	13.5	8.0	12.8	27.5	14.5

Source: State Statistics Committee, NBU, State Treasury, IER forecasts and estimates