# Ukraine Macroeconomic Situation

December 2005

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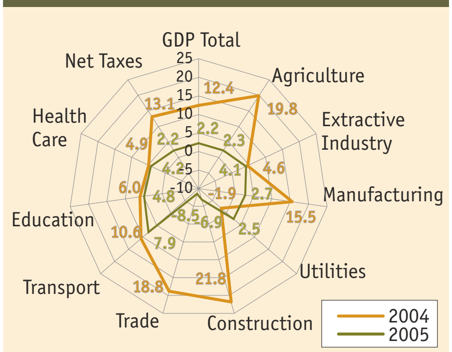
## Summary


- Over January-November, Ukrainian economic growth reported a 2.2% year-over-year (yoy) increase; the whole year economic growth may accelerate slightly to 2.4% yoy due to a lower base.
- A 90% increase in imported gas prices in January 2006 will have a significant impact on Ukraine's macroeconomic performance in the short-run; however, the economy may benefit in the medium-run from introduction of energy-saving technologies.
- In January-October, the consolidated budget remained in surplus at 1.6% of GDP.
- The parliament approved the 2006 budget with a targeted deficit of about 2.6% of GDP and a number of risks.
- Consumer price inflation continued to decelerate. The trend is expected to continue next year; however, year-end inflation this and next year are unlikely to return to single digits.
- Although the merchandise trade balance will continue to worsen through the rest of the year, the current account balance will remain in surplus thanks to a positive balance of services trade.
- Net inflow of FDI will reach a record high level in 2005 due to the successful re-privatization of Kryvorizhstal and a number of acquisitions in the banking sector.


## Economic Growth

In November, a substantial decline of value added in domestic trade and the continuing slowdown in industry contributed to a reversal of GDP growth dynamics. During the month, real GDP declined by 2.7% yoy after encouraging growth at 3% yoy in September and 2.2% yoy in October. As a result, cumulative economic growth slowed to 2.2% yoy. During the year, the government revised its full-year GDP forecast downwards several times from the initial 8.2% yoy to 3.2-3.5% yoy at the beginning of December. However, based on Ukraine's economic performance during eleven months of the year, we believe 2005 growth will amount to 2-2.4% yoy.

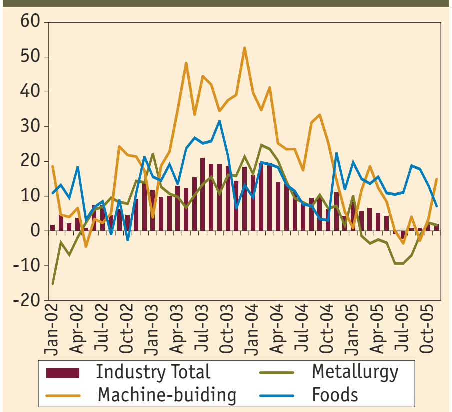
**GDP Growth by Sector in January-November, % yoy**




Source: State Statistics Committee

Despite a good harvest this year and an easing high base effect, value added growth in agriculture remained quite moderate at 2.3% yoy over the period. Domestic trade, which accounts for more than 12% of the total value added, reported an 8.5% yoy decline, twice as large as in the previous period. By structure, it was wholesale trade that reported an almost 15% yoy decline over January-November as retail trade turnover continued to grow, benefiting from the population's increased income. Wholesale trade was affected by poor merchandise export performance and decelerating domestically-oriented industries, because domestically produced products account for 73.4% of the total wholesale trade turnover according to official statistics. Over January-November, value added in construction reported a 6.9% yoy decline, the same rate as in the previous period. Contraction in the sector this year is attributed to a high base effect due to a number of infrastructure and repair works last year. On the upside, transport was the main contributor to period GDP growth, accelerating to 7.9% yoy.

**Industry Growth - Selected Sectors, % yoy**




Source: State Statistics Committee

Ukraine's industrial production continued to decelerate, with output reporting 2% yoy growth in November (down from 2.4% yoy in October) and 2.9% yoy in January-November. In the corresponding period last year, industrial output grew by 13.4% yoy, underpinned by an impressive 15.5% yoy increase in manufacturing. This year, manufacturing production decelerated to 2.7% yoy on the back of a contraction in metallurgy and oil refining and a considerable slowdown in machine-building. Difficulties in metallurgy are primarily explained by worsening export opportunities for steel products. Over January-November, metallurgical production declined by 2.1% yoy. However in November, industry continued to recover, demonstrating a 1.7% yoy increase in output. The growth in metallurgy over the last two months may be attributable to the stabilization of world steel prices during September-October. Machine-building production picked up to 15% yoy in November thanks to recovered external demand. As a result, cumulative growth expanded to 6.1% yoy over January-November, up from 5.2% yoy in the previous period. Food processing demonstrated healthy 13.7% yoy growth since the beginning of the year. Benefiting from high external demand, the traditionally sluggish extractive industry and utilities demonstrated 4.1% yoy and 2.5% yoy growth over the period, respectively.

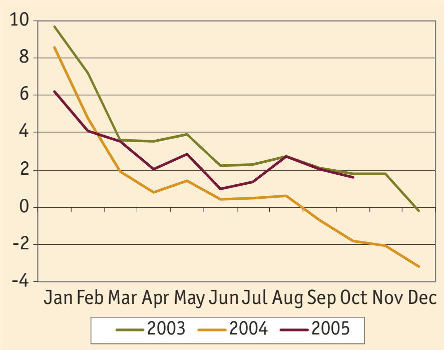
Until recently, the government forecasted GDP growth at 7% yoy in 2006, inflation at 9.7% yoy and a consolidated fiscal deficit at 2.5% of GDP. Although international organizations were more modest in their estimates, forecasting GDP growth at 5-5.5% yoy and double digit inflation, the overall economic performance looked encouraging. Domestic demand is expected to be robust next year, although the growth rates will be lower compared to this year due to a high base effect and more moderate income growth. Investment activity in the first half of 2006 will be affected by political uncertainty due to parliamentary elections and enforcement of changes to the constitution; however, it is expected to rebound in the rest of the year. The prospects for Ukrainian exports are not very favorable next year because of the expected slowdown in the world economy. At the same time, while world steel prices are forecasted to continue to decline next year, the trend will be much flatter than this year and prices will remain at a fairly high level. However, almost twofold increase in imported gas prices for Ukraine since the beginning of 2006 dramatically changed the prospects for the country's economy.

Ukraine inherited a very energy intensive industrial sector from the Soviet period. Being one of the largest consumers of natural gas in the world, Ukraine did very little to reduce its gas consumption since independence. Although Ukraine has its own gas resources, domestic gas production accounts for about 25% of the demand. The remainder is imported from Russia and Turkmenistan (about 35% and 40%, respectively). According to a barter arrangement with Russia, in 2005 Ukraine received about 24 billion cubic meters ($m^3$) of gas each year at a price \$50 per 1000 as a payment for transit of about 125 billion $m^3$ of Russian gas to Europe. The transit fee was set at \$1.09 per 1000 $m^3$ per 100 km. According to the new agreement between Ukraine and Russia, starting January 1st 2006 the new gas price for Ukraine will be \$95 per 1000 $m^3$ at the Russian-Ukrainian border. Although the higher gas bill for Ukraine will be partially offset by an increase in the transit fee to \$1.6 per 1000 $m^3$ per 100 km, the increase in gas prices will have a significant impact on Ukraine's economy in the short run. In particular, GDP may show meager growth or even decline in 2006 as energy imports will increase and a number of export-oriented industries (such as chemicals and metallurgy) will be affected. In addition, the hike in gas prices will lead to higher inflation, a larger consolidated fiscal deficit and a reversal of current account balance from surplus to moderate deficit. On a positive note, an increase in gas prices will stimulate investments in energy-saving technologies and hasten the adjustment of tariffs to cost-recovery levels. In the medium-run, it should lead to a diversification of the economy and improvements in energy conservation.

## Fiscal Policy

Despite the generally poor performance in the real sector, the consolidated budget posted a surplus of UAH 5.3 billion (about \$1.05 billion) over January-October, which is equivalent to 1.6% of period GDP. The surplus was achieved thanks to a considerable increase in tax proceeds due to elimination of a number of tax privileges at the beginning of the year and improved tax compliance, as well as payments of enterprise profit tax in advance. As of December 1st, VAT refund arrears were almost fully repaid according to the Ministry of Finance. Over January-October, consolidated budget revenues went up by a real 33.8% yoy to reach UAH 105.7 billion ($20.9 billion), while expenditures grew by a more moderate 19.4% yoy to UAH 100.3 billion ($19.9 billion). However, due to further increases in social payments at the end of the year, the expected state budget deficit will reach UAH 9.53 billion, or 2.3% of forecasted full-year GDP as envisioned in the amended 2005 State Budget.

**Consolidated Budget Balance, % of period GDP, 2003-05**



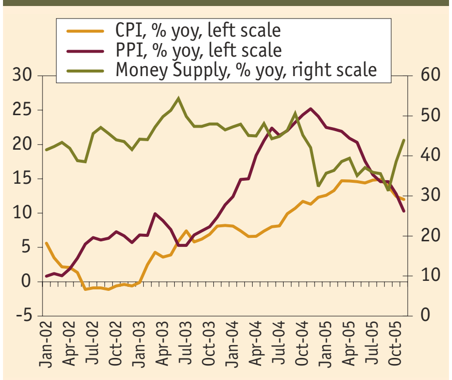

Source: Ministry of Finance

Following three months of tough debates, the parliament approved the 2006 budget with the targeted deficit of about 2.6% of GDP at the end of December. The budget, which is considered a political rather than an economic compromise, contains a number of risks. First, it was developed based on quite optimistic macroeconomic indicators (in particular, 7% yoy economic growth). Second, despite the generally accepted view that following the large hike in social spending in 2004-2005 future budgets should focus on economic development and investment needs, the 2006 budget envisages further increases in minimum wages, pensions, the subsistence level and other social outlays. Third, a small reduction in several tax rates next year (a meager 1 percentage point (pp) cut in the payroll tax rate and a 0.2 pp reduction in the pension duty on foreign exchange sales to 1.3%) do not do much to ease the tax pressure for businesses. Due to the upcoming parliamentary elections, the long-awaited comprehensive tax reform is unlikely to commence before 2007. And last but not least, the adopted budget was developed keeping the gas prices imported from Russia and Turkmenistan unchanged. Most likely, the budget will be amended shortly after March's parliamentary elections.

## Monetary Policy

Despite the accelerating consumer price index (CPI) on a month-to month basis, it continued to decline in annual terms, reporting a 12% yoy increase in November (down from 12.4% yoy in the previous month.) Monthly inflation picked up to 1.2% in November, driven by a 1.4% month-over-month (mom) increase in food prices. However, food prices continued to decelerate to 13.2% in annual terms, down from 13.6% yoy a month ago. Some increase in annual prices for vegetables, sugar and bread was compensated for by decelerating prices on meat, milk and cereals. In annual terms, the non-food price index was on a declining trend, reporting a 4.8% yoy increase in November (down from 5.1% yoy in October) as price deceleration was observed for most non-food commodities. Following the stabilization of world prices, domestic gasoline prices declined for the second month in a row (down by 2.8% mom). However, affected by high gasoline prices in previous periods, transportation tariffs continued to increase, although at a slower pace. In November, transportation tariffs grew to 26.8% yoy, up from 26.1% yoy in October. On account of the high base in the previous year, the cost of public utilities decelerated to 12.8% yoy in November, down from 14% yoy a month before. As a result, the growth of service tariffs slowed to 14.2% yoy. In November, the producer price index (PPI) continued to decelerate. Reporting a 10.3% yoy increase in November (down from 12.8% yoy in October), producer inflation was below consumer inflation for the fist time since mid-2003.

**Prices and Money Supply Dynamics, 2001–05**

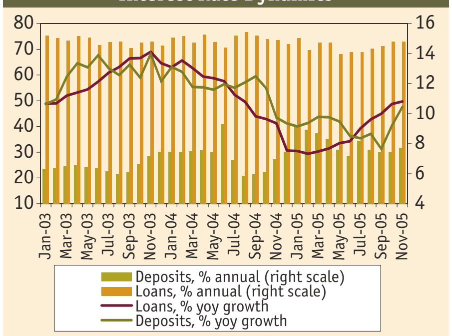



Source: State Statistics Committee, National Bank of Ukraine

Year-end consumer inflation will most likely be lower than last year's, but will remain in double digits at around 11% yoy affected by the surge in the population's income and a number of supply side shocks (e.g., the rapid increase in world oil prices). For next year, the government forecasts inflation to decline to 9.7% yoy. However, the high oil prices that affected transportation tariffs this year may continue to pressure inflation next year too as a spillover effect on other prices. The sharp increase in gas prices in 2006 will lead to an upward revision in administered prices. At the end of December, the government announced a 20% hike in electricity tariffs for the population with the consequent 10% increase each quarter to reach cost-covering level. Moreover, gas tariffs for both industrial producers and households will be increase by 25% on average at the beginning of 2006. In addition, loose fiscal policy next year and the NBU's firm intention (expressed in 2006 Monetary Policy Guidelines) to maintain a de facto exchange rate peg will make the NBU's task of reducing inflation to single digits difficult to achieve.

During November, the growth of monetary aggregates was rather moderate as money supply advanced by 0.3% mom while money base reported a decline of 2.8% mom. However, due to money transferring to the former owners of Kryvorizhstal on the last day of the month, the growth rates of the respective aggregates accelerated to 3.1% mom and 4.6% yoy respectively. As a result, the money base accelerated to 49.6% yoy in annual terms (up from 34.6% yoy in October), while the money supply increased by 44% yoy (up from 38.5% yoy.) Due to the shortage of liquidity (currency in circulation increased by a meager 0.3% mom in November), commercial banks increased their deposit rates to an average of 7.7%, up from 7.4% yoy during September-October. Affected also by a low base, this led to an acceleration of the deposit growth to 47.6% yoy, up from 40.6% yoy in the previous month. This, in turn, allowed for further expansion of private sector lending. During the month, the growth of domestic credit increased to 49.7% yoy, 1 pp higher than in the previous month.

**Loans and Deposits Growth and Interest Rate Dynamics**



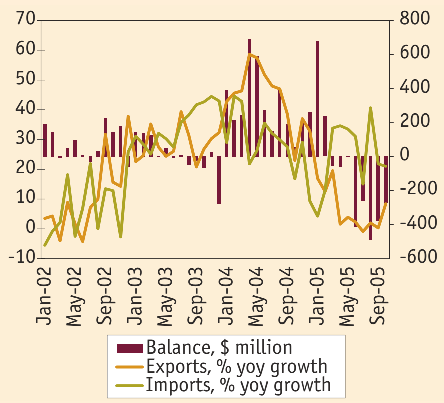

Source: National Bank of Ukraine

During December, the foreign exchange market was almost balanced and the NBU did not intervene in the market. As a result, the official exchange rate remained stable at 5.05 UAH/USD, while international reserves increased only marginally from the surge at the end of November. On the contrary, the cash exchange rate showed a slight depreciation in the second half of December, which may be explained by increasing uncertainly related to the gas price issue and the upcoming parliamentary elections.

## International Trade and Capital

Over January-October, Ukraine's merchandise foreign trade balance continued to worsen, reporting a more than $1 billion deficit. Robust growth of domestic demand and high world crude oil prices contributed to the 25.3% yoy growth in imports. At the same time, exports showed a meager 6.3% yoy increase over the period affected by weaker external demand for steel products, sharp national currency appreciation in April and general cooling of Ukraine's economy. Imports growth is expected to be high next year closely linked with a further rise in population incomes, the anticipated rebound in investment activity and more expensive energy imports. As steel prices are forecasted to continue falling next year and a number of export-oriented industries (like metallurgy and chemicals) may be severely affected by a possible sharp increase in gas prices or gas shortages, export growth is expected to be quite moderate. This will lead to further widening of the trade deficit next year.

**Merchandise Trade Performance, % yoy growth**

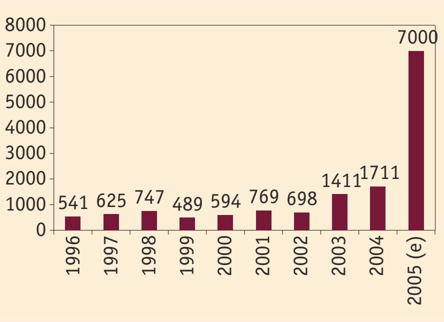



Source: State Statistics Committee

By product breakdown, cross border metals sales continued to slow, reporting a 12.8% yoy increase over January-October versus 14.1% yoy over January-September. Slight acceleration of metals export growth to 2.5% yoy in October may be explained by an upward trend of world steel prices in September and almost stable prices in October. An expansion of machinery and equipment exports at 20.7% yoy in October, although encouraging, may reflect the softening high base effect. Cumulatively, machinery and equipment exports declined by 9.1% yoy. On the import side, energy resources and investment goods such as machinery and equipment remained the two largest items of merchandise import, accounting for 33.4% and 17.2% respectively. Over January-October, imports of machinery and equipment increased by about 34.4% yoy while imports of energy reported a 8.6% yoy increase. The geographical breakdown of Ukraine's foreign trade reveals an increasing export bias towards Russia, whose share of total exports increased from about 18% in 2004 to 21.6% at the end of November. On the import side, the share of CIS countries in total imports, and Russia in particular, declined slightly in favor of European countries. In January-November, European countries' and Russia's shares constituted 34.1% (up from 32.6% in 2004) and 36.6% (down from 40.7%) respectively.

Deterioration of merchandise foreign trade was compensated for by the strong position of Ukraine's foreign trade of services. According to the NBU, the nine-month service trade balance reported a $933 million surplus, which is more than 8% yoy higher. Over the period, the current account surplus shrunk by almost 63%; however, it remained in surplus of $2.1 billion, which is equivalent to 0.7% of period GDP. Although the current account will continue to worsen, it is unlikely to turn into a deficit by the end of the year.

**Net FDI Flows, $ million**




Source: National Bank of Ukraine, The Bleyzer Foundation estimate

Despite a considerable economic growth slowdown, Ukraine will post record FDI inflows this year. Although the net FDI inflow was almost 25% yoy lower in January-September, successful re-privatization of metallurgical plant Kryvorizhstal and a number of acquisitions in the banking sector will boost FDI to a record high $7 billion.

## International Programs

In mid-December, the Verkhovna Rada ratified an agreement between Ukraine and the World Bank (WB) signed in September. The $106 million is loaned for reconstruction of nine hydroelectric power stations. Reconstruction is expected to be completed by the end of 2011, while the loan is granted for 18.5 years with a grace period of 6 years and a LIBOR + 0.75% interest rate.

At the end of November, the WB announced that it completed the preparation of two more projects totaling $290 million. The Bank plans to allocate $150 million to improving the rural population and municipalities' access to financial services. The other project is designed to provide loans to local governments and utilities for priority investments in improving infrastructure (water supply, waste-processing systems, etc.) In mid-November, another $99.4 billion project started aimed at modernization of the social assistance system.

In mid-December, the European Bank for Reconstruction and Development announced its intent to invest about EUR500 billion in Ukraine. The investments will be directed at mortgage, energy saving, leasing and other programs. Out of that amount, EUR 40 billion is reserved for SigmaBleyzer's Southeast European Fund IV.

## Other Developments and Reforms Affecting the Investment Climate

On November 26th, the parliamentary election campaign officially started in Ukraine. 52 political parties and blocks expressed the intent to participate in the elections. For the first time, elections will be held on a proportional vote system replacing the mixed (proportional-majority) vote system. Moreover, the parliament will be elected for five years instead of the previous four years. According to the polls, about six political parties have a chance to pass the threshold requirement of 3%. The Party of Regions of Ukraine headed by Mr. Yanukovich, the former rival of President Yushchenko during the presidential elections last year, holds the leading positions. The others are the People's Union of Our Ukraine, Yulia Tymoshenko's Block, the People's Block of Lytvyn, and the Socialist and Communist parties.

Starting on January 1st, 2006, the changes to the Constitution of Ukraine will be partially enforced, although a number of important provisions will be fully effective after the parliamentary elections on March 26. The constitutional reform envisages a shift to a parliamentary-presidential republic, reducing presidential power and giving more authority to the Parliament. In particular, the power of the President of Ukraine is limited to the appointment of the Prime Minister upon the formation of a majority coalition in the Parliament, and the appointment of the Minister of Defense, the Minister of Foreign Affairs, the Head of the National Bank, and the Prosecutor General with the subsequent approval of the Parliament. However, the President will have the right to dissolve the Parliament if it fails to form a majority coalition within one month of parliamentary elections or if it fails to form the Cabinet of Ministries within 60 days of the Cabinet's resignation. In case of the Parliament's dissolution, the Cabinet of Ministries will also be automatically dismissed. The powers of the Parliament of Ukraine were widened to include the right to approve other Ministers (except those mentioned above) and heads of key state committees by motion of the Prime Minister, without the need for Presidential approval. In case of early termination of the President's powers, the Head of the Parliament (not the Prime Minister) will act as President until the new presidential election.