# Ukraine
# Macroeconomic Situation

November 2006

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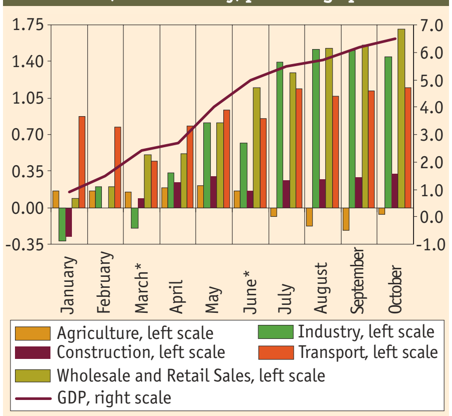
## Summary


- In October 2006, Ukraine continues to show remarkable economic growth as real GDP expanded by 9% yoy, bringing the cumulative figure to 6.5% yoy.
- Strong GDP growth helped to maintain fiscal stability in the country; during January-October the consolidated fiscal surplus stood at 0.4% of period GDP. Nevertheless, the government expects to incur a fiscal deficit of 2.5% of GDP in 2006.
- Driven by continuing adjustment of utility tariffs, consumer price inflation surged up to 11% yoy in October.
- Despite improving export performance, Ukraine's merchandise trade deficit continued to increase. However, thanks to surpluses in foreign trade of services and transfers accounts, the current account deficit narrowed to just $202 million (0.3% of period GDP) for January-September.
- In November — beginning of December, Ukraine accelerated the adoption of legislation necessary for WTO accession.


## Economic Growth

The Ukrainian economy continued to demonstrate remarkable economic performance in October. Supported by robust domestic demand, GDP grew by 9% yoy during the month. For the first ten months of the year, total GDP stood at UAH 400 billion (almost $80 billion), 6.5% up compared to January-October of the previous year.

**Real GDP Growth by Selected Sector Contributions in 2006, cumulatively, percentage points**



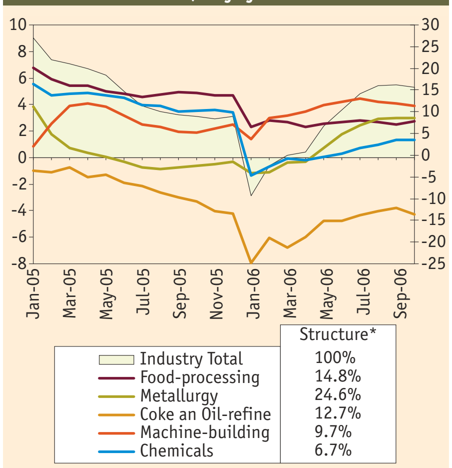

* Revised figures
Source: State Statistics Committee, The Bleyzer Foundation

Though the industrial sector witnessed a deceleration of value added growth in October, it was more than compensated for by the growth in the service sector. Acceleration of value added growth in domestic trade and transport to 15% yoy and 9.5% yoy respectively explained almost 45% of total GDP growth over January-October. Strong payable demand for residential housing and industrial buildings supported the dynamically growing construction sector where value added expanded by 8.4% yoy, up from 7.6% yoy over the first nine months of the year.

The good harvest of vegetables, sugar beets and sunflower seeds, as well as the healthy rates of growth in livestock farming, improved agricultural performance; however, its contribution to total GDP growth remained negative. In particular, value added in agriculture declined by 0.7% yoy over January-October, picking up from a 2.3% yoy decrease over January-September. A successful winter crops sowing campaign, favored by good weather conditions, should allow the sector to report marginal growth for the full year.

In October, industrial output growth slowed to 3.8% yoy compared to 6.2% yoy growth a month before. Nevertheless, the cumulative growth rate is still reasonably high — 5.3% yoy at the end of October. The major reason for the slowdown was a sharp reduction of output in the coke and oil-refining industry. Since mid-2005, when import tariffs on oil products were substantially reduced, the oil-refining industry faced increasing competition from higher-quality imports. In 2006, it was exacerbated by the price hike on energy resources and rising input costs. Though world crude oil prices eased in the last few months after reaching a peak in mid-July, they still remained at a high level. In addition, after a series of increases, Russia's crude oil export duty reached record high level of $237.6 per ton in October ($179.6 per ton at the beginning of the year). All of these factors resulted in imports displacing domestic production of gasoline. At the same time, the output decline by almost 30% yoy in October (compared to 5.3% yoy a month before) was caused by routine repairs at two oil refineries.[1]

**Industrial Output by Selected Industries, 2005–2006, % yoy cumulative**



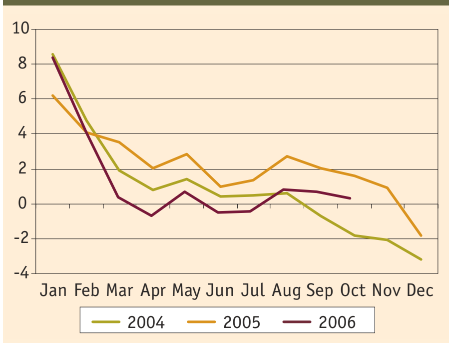

* Approximation based on industrial sales statistics in January-October 2006
Source: State Statistics Committee

Though machine-building, metallurgy and the chemical industry, accounting for more than 40% of total industrial output, reported deceleration of production, the cumulative growth rates remained at a decent 11.3% yoy, 8.5% yoy and 3.5% yoy respectively. October's deceleration in these industries may be attributed to weakening external demand and an easing low base effect. Supported by buoyant consumption growth and anticipation of Russia's elimination of export bans on Ukraine's milk, meat and dairy products, production of foods accelerated to 12% yoy in October, bringing the cumulative growth to 7.8% yoy.

Despite price hikes on energy resources (particularly natural gas and crude oil), the Ukrainian economy was able to absorb the shocks. Real GDP is expected to show strong growth of around 6.5% yoy in 2006, a rate that favorably compares to Central and Eastern European countries. Good macroeconomic performance in 2006, robust domestic consumption and investment activity (both domestic and foreign) should allow GDP to grow by 5-6% yoy in 2007 even considering a 37% increase in imported natural gas prices. However, Ukraine's economy remains quite vulnerable to developments in energy and steel prices.[2] Hence, the positive macroeconomic outlook in future periods will crucially depend on Ukraine's ability to speed up fundamental economic reforms, necessary to improve business environment and stimulate investments, including into energy-saving technologies.

## Fiscal Policy

**Consolidated Budget Balance, % of period GDP, 2004–2006**




Source: Ministry of Finance

Strong GDP growth helped to maintain fiscal stability in the country. Booming domestic trade, growing household income and improving enterprise performance allowed the government to over-fulfill budget revenues. In particular, tax revenues to the general fund of the state budget were collected in an amount exceeding the target by 10.3% in October and 3.2% to date. VAT proceeds, the weightiest component of tax revenues, exceeded the target by 22% in October and 17.4% to date. At the same time, a 40.5% yoy increase in VAT receipts in nominal terms over January-Octo-

[1] There are six oil refineries in Ukraine. Two of them are not functioning since the beginning of the year due to planned repairs and fundamental reconstruction. In October, two more oil refineries stopped for two-week routine repairs.

[2] Despite the fact that the price for imported natural gas for Ukraine was increased by about 42% in 2006 and will be raised by another 37% in 2007, Ukraine will be paying only about 46% of the "European" price.

ber was achieved partly due to an accumulation of VAT refund arrears. In particular, VAT refunds were under-fulfilled by 39.5% in October and almost 14% for the first ten months of the year. As the financial stance of enterprises continued to improve (the share of profitable enterprises increased to 64.4% over January-September, while profits before taxes were up by 13% yoy), corporate tax (EPT) collections have also been recovering. Thanks to above-target collections in the last few months (by 10% in October), cumulative execution improved but remained 10.7% below the targeted amount.

Expenditures from the general fund of the state budget were up 22.8% yoy in nominal terms over January-October. At the same time, they were under-executed by 12.7% in October and 4.8% to date. However, in spite of the over-fulfillment of revenues and under-execution of expenditures, the state budget deficit widened to UAH 2.7 billion (0.7% of period GDP), an increase from a UAH 1.4 billion deficit over January-September.

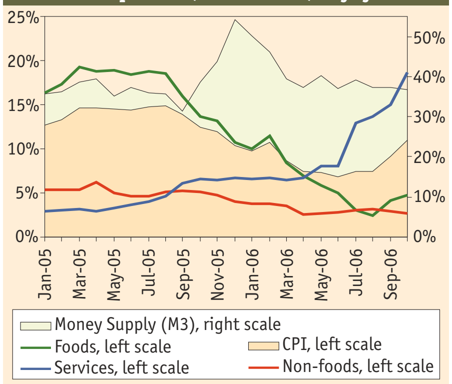
Large surpluses in local budgets allowed the consolidated budget to stay in surplus of UAH 1.5 billion or 0.36% of January-October's GDP. Nevertheless, the government expects to incur a deficit of 2.5% of GDP in 2006. This implies considerable fiscal loosening through the end of the year. Moreover, to meet all social liabilities, the government had to amend the 2006 budget law. In mid-November, the parliament approved amendments to the budget envisaging revenue and expenditure increases by 1.4% to UAH 127.5 billion ($25.3 billion) and UAH 140.2 billion ($27.8 billion), while the deficit was kept unchanged. Social expenditures will be increased thanks to extra budget revenues received from over-fulfillment of VAT proceeds, saved funds from lower expenditures for the election process and servicing public debt, and reallocation of other expenditures.

Though the government resumed both domestic and external borrowings in September-October, the rest of the funds received from the re-sale of metallurgical plant Kryvorizhstal in October 2005 remained the primary source of state deficit financing. The absence of public borrowing in the first eight months of the year on the back of prudent public debt servicing resulted in a 6.7% reduction of total public debt since the beginning of the year to $14.4 billion (about 14.4% of projected full year GDP). However, to fully realize planned budget expenditures for 2006, the government stepped up borrowing activity. Thus, it successfully placed $1 billion Eurobonds with a 10 year maturity and 6.58% yield in November. This will cause slight acceleration of public debt through the end of the year; however, its level will remain among the lowest among peer countries.

## Monetary Policy

Driven by continuing adjustment of utility tariffs, consumer price inflation surged up by 2.6% month-over-month (mom) in October. Such high monthly inflation had not been observed since fall 2000. In annual terms, CPI growth approached 11% yoy.

**Dynamics of Money supply, CPI and Its Major Components, 2004–2006, % yoy**




Source: State Statistics Committee, National Bank of Ukraine

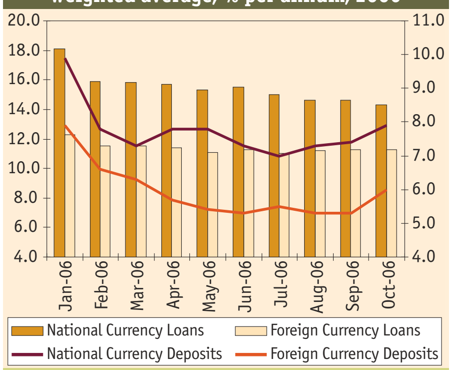
During the month, service tariffs increased by 7.8% mom, driving the annual growth to 41% yoy. The largest increase was registered for utility and housing tariffs — 71.6% yoy in October. In the run up to the heating season, local authorities raised the cost of heating, hot water supply and housing services in a number of regions. The process of tariffs adjustment to cost covering levels differs in speed and magnitude throughout Ukraine. Service inflation is expected to further accelerate through the end of the year, as several times tariff adjustment in Kyiv, one of the weightiest components of Ukraine's economy, is scheduled for December 1st. Though painful for end-users, the adjustment of service tariffs to cost-covering levels may help restore the solvency of the utility sector, enhance sector modernization and prompt more efficient utilization of utilities.

Besides services, October's inflation was also driven by food price growth. Following the upturn in September, food price inflation accelerated to 1.4% mom, which translated into a 4.7% yoy increase in annual terms. The price growth acceleration was reported for bread and cereals (which can be explained by the adjustment to higher production costs), meat, milk and dairy products (related to expectations of elimination of Russia's ban on Ukraine's export of these products.) Following the pattern of world crude oil prices, domestic gasoline prices declined by 6.1% mom in October. This allowed non-food prices to decelerate in annual terms to 2.7% yoy.

In November, the pace of inflation may decelerate as the government negotiated a further decrease in gasoline prices with gasoline traders and initiated the revision of price levels on selected food products (meat, milk, sugar). However, these efforts may be outweighed by growing demand side pressures. An upward adjustment in the subsistence level and minimum pensions as of October 1st, anticipated considerable fiscal loosening at the end of the year, and booming credit to the private sector on the back of high inflationary expectations will largely contribute to inflationary pressures in the coming months. Hence, we believe that year-end inflation will be around 11.5% yoy.

The monetary impact on inflation has remained moderate so far. Though monetary base growth accelerated to 22.4% yoy, money supply growth continued to decelerate to 36.7% yoy. In monthly terms, the monetary base expanded by 3.5% driven by the NBU's net foreign exchange purchases on the interbank market, which amounted to $363 million in October, and the decline of government cash balances on the account with the NBU by 8.3%. Their impact, however, was mitigated by the increase in commercial banks reserves kept at the corresponding accounts with the NBU following the increase of mandatory reserve requirements since October 1st. At the same time, the money supply reported a moderate increase of 1.8% mom due to the decline in the money multiplier. Moderate money supply growth was accompanied by increasing money demand, with the latter stimulated by robust growth of household income, improved access to commercial banks' credit resources and recovered investment and business activities.

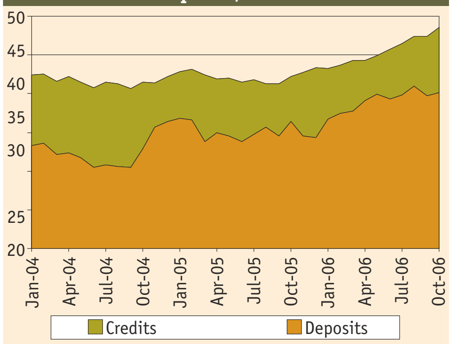
**Lending and Deposit Rates by Currency, weighted average, % per annum, 2006**




Source: National Bank of Ukraine

Decent growth of deposits (up by 41.8% yoy in October), the NBU's refinancing operations and active borrowing from abroad allowed the commercial banks to keep their lending growth rates at a high 66.1% yoy in October. Differentiation of reserve requirements by currency resulted in acceleration of national currency deposits growth to 33.3% yoy in October and deceleration of foreign currency deposits to 56.7% yoy (down from 64.1% in September). At the same time, to make deposits more attractive in light of recent acceleration of consumer inflation, commercial banks had to increase deposit rates. However, quite different patterns were observed for national and foreign currency borrowings. The lending rate on hryvnia-denominated loans has been declining throughout the year to 14.3% pa in October, while the rate on foreign currency loans increased from 11% pa in July to 11.3% pa in October. However, Ukrainians still prefer borrowing in foreign currency. In particular, foreign currency loans accelerated to 91.1% yoy in October, bringing their share to 48.5% at the end of October compared with about 43% at the beginning of the year.

**The Shares of Foreign Currency Loans and Deposits, % of total**



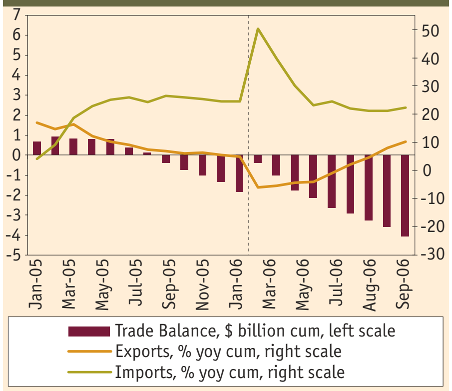

Source: National Bank of Ukraine, The Bleyzer Foundation

## International Trade and Capital

Favored by strong external demand, Ukraine's export performance continued to improve. In September, for the fourth month in a row, merchandise exports reported higher rates of growth than imports — 31% yoy and 29.4% yoy respectively. However, due to poor performance in the first half of the year, the cumulative growth of imports considerably outpaces exports. In particular, exports increased by 10.4% yoy over the first nine months of the year while imports expanded by 22.2% yoy. As a result, the merchandise trade deficit continued to widen, reaching $4.1 billion at the end of September, which is equivalent to about 5.1% of period GDP.

By product breakdown, the largest contributors to the overall growth of goods exports remained metals, whose trading volumes expanded by 12.4% yoy over January-September, followed by machines and transport equipment and chemicals. On the import side, imports of machines and transport vehicles expanded by about 37%, indicating strong investment demand in the country. However, traditionally the largest contributor to merchandise imports growth remained oil and gas imports. Accounting for 30% of total imports, imports of energy resources were up 18% yoy over the first nine months of the year.

**Merchandise Trade Flows in 2004–2006**




Source: State Statistics Committee

Despite a widening merchandise trade deficit, Ukraine's current account balance has been improving. According to preliminary estimates of the NBU, the CA deficit declined to $202 million at the end of September, down from a $782 million deficit reported for the first half of 2006. The CA surplus in the third quarter of the year was achieved on account of surpluses in the foreign trade of services and transfers accounts. Indeed, the State Statistics Committee reported a $2.4 billion surplus in Ukraine's foreign trade of services. Considering recent balance of payments improvements, the CA deficit may be around 0.5% of GDP for the year. Plentiful FDI, estimated at $3.6 billion as of the end of September, allowed the country to not only finance CA deficit but also replenish international reserves ($19.5 billion at the end of October).

## Other Developments and Reforms Affecting the Investment Climate

Following Fitch's upgrade of Ukraine's long-term rating outlook, Moody's has also revised its outlook for Ukraine's B1-rated medium and long-term government bonds in foreign and national currency and its "B2"-rated foreign currency bank deposit ceiling to positive from stable. According to agency experts, the revision was due to the greater political stability following the appointment of the new coalition government.

As of the end of November, Ukraine had completed bilateral agreements with all countries but Chinese Taipei and Kyrgyzstan. Hence, bringing legislation into compliance with WTO requirements remained the main stumbling block on Ukraine's way to WTO accession. In November — beginning of December, Ukraine accelerated the adoption of legislation necessary for WTO accession. In particular, the amendments to the laws regulating banking, insurance, veterinary industries, export duties on live cattle and raw stock taxation on agriculture, export duties on iron and steel and non-ferrous scrap were adopted. Ukraine hopes to obtain a positive report at the organization's meeting on December 21st and join the WTO in early 2007. Moreover, it is enhanced by the recent agreement on WTO between Russia and the USA. This agreement raises the chances of Ukraine's and Russia's synchronized entry into the organization.

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