Ukraine
Macroeconomic Situation

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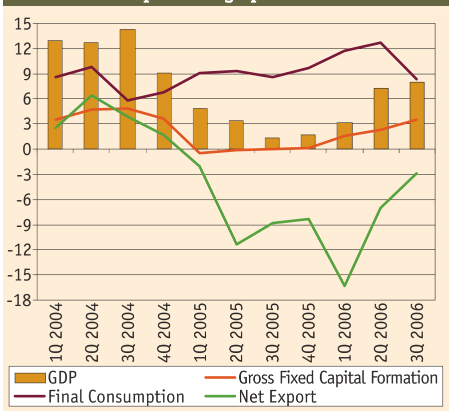
Summary

- Ukraine achieved a remarkable macroeconomic outcome in 2006 despite a 45% price hike in imported gas, political uncertainties and fluctuations in world steel prices. According to preliminary data, the Ukrainian economy grew by 7% yoy in real terms.
- Good GDP growth, more moderate increases in recurrent expenditures and improvements in the collection of budget revenues allowed the government to maintain a low consolidated fiscal deficit at 0.7% of GDP.
- Consumer prices grew by 11.6% yoy in 2006, driven by energy-price pass-through.
- 2006 was another year with a credit boom, as credits to the real sector and households surged 71% yoy.
- The merchandise trade deficit widened to $5.3 billion or about 5% of estimated full-year GDP; however, the current account is estimated to be around 1% of GDP.
- On January 24th, 2007, an Investment Council under the Cabinet of Ministers was created.

Economic Growth

According to preliminary estimates of the State Statistics Committee (SSC), Ukraine's GDP grew by 7% yoy in 2006, considerably exceeding the 2.5% yoy growth forecasted at the beginning of the year. Though the nominal value of GDP for 2006 (as well as its components) was not released, GDP is estimated at UAH 527.3 billion ($104.4 billion). The better-than-expected GDP growth was supported by the continuing consumption boom, recovered investment activity and improved export performance.

Contributions to GDP Growth, 2004–2006, percentage points



Source: State Statistics Committee, The Bleyzer Foundation

Consumption was the main contributor to economic growth. During the first nine months of the year, private consumption advanced by a record high 18.8% yoy, underpinned by robust growth of real household disposable income and favorable credit conditions. Some slowdown in the second half of the year reflected decelerating real household disposable income and energy price pass-through on services tariffs. In turn, the slowdown in real household income was the result of more moderate real wage growth and social security payments. Although decelerating, real household income grew by a decent 16.3% yoy over January-November 2006. Unlike private consumption, government spending declined by 4.1% yoy in 3Q 2006 primarily on account of collective consumption expenditures, which dropped by 11.6% yoy over the quarter. The decline mirrored the government's approach to postpone some of the budget expenditures in light of possible lack of budget deficit financing. As of the end of September, privatization proceeds accounted for just 16% of the target while new borrowings on the domestic and external markets were resumed only in September. As a result, expenditures from the general fund of the state budget were under-executed by almost 4% as of end of September.

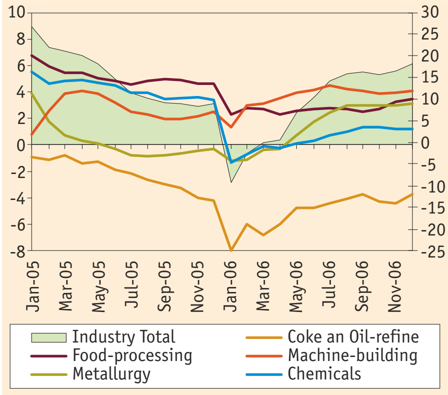
Following a small decline in the previous year, investments demonstrated a strong 12.1% annual growth in January-September 2006. Though political uncertainties persisted throughout the year, investments were driven by the need to strengthen productivity, innovation and competitiveness in view of growing production costs (due to more expensive energy resources) and imports. This is accomplished through modernization of obsolete production capacities, introduction of energy-saving technologies, R&D efforts and exploitation of advantages in organization structure, marketing, logistics, etc. Improved access to borrowed funds (both domestic and foreign) was an important impetus to robust investment growth this year.

Favorable external conditions allowed exports of goods and services to report real 1.3% yoy growth in 3Q 2006, which was not observed since the end of 2004. Despite accelerating imports (up by 7.1% yoy in real terms for 3Q 2006), the negative contribution of net exports to GDP was further reduced.

On the production side, the increase in real GDP primarily reflected positive contributions of service and industrial sectors. Buoyant consumption growth supported further expansion in domestic-oriented sectors and industries. Thus, retail sales increased by 24.8% yoy in 2006, passenger turnover grew by 4.4% yoy, output in the food industry was up 10% compared to the previous year, construction of buildings (mostly residential) rose by 12.8% yoy. Favorable external conditions and robust investment activity underpinned output growth in machine-building (11.8% yoy), metallurgy (almost 9% yoy) and utilities (6.7% yoy).

The chemical industry demonstrated an encouraging 3.2% yoy increase in output, considering the 45% increase in the price of imported gas (natural gas accounts for up to 80% in production costs for certain chemical products). At the same time, the industry's prospects for 2007 are not favorable. Despite forecasted moderate growth in international prices for chemicals in 2007, profit margins in the export-oriented but energy-intensive industry will further deteriorate due to a 37% increase in imported gas prices starting at the beginning of 2007. At the same time, chemical producers are actively seeking government support for the industry, lobbying a draft law "On chemical industry support". If successful, the chemical industry may show reasonable performance in 2007. However, the increase in sectoral subsidies may bear efficiency losses to the country and inhibit the industry's restructuring.

Industrial Output by Selected Industries, % yoy cumulative



Source: State Statistics Committee

Robust growth of industrial output, which expanded by 6.2% yoy in 2006, contributed to value added growth in wholesale trade (wholesale turnover rose by 13.6% yoy), cargo transportation (turnover was up 4.2% yoy), and construction. According to SSC data, industrial output surpassed 1990's level by about 0.8 percentage points, while GDP is still lagging behind. At the same time, such comparisons should be treated with some caution due to structure and price distortions that were present in 1990. To a large extent, industrial output in 1990 was led by the military sector while prices and volumes of production were determined by the government. Moreover, countries that belonged to the Soviet Union, particularly Russia, were the primary outlet for Ukrainian goods. Now, CIS countries account for less than one third of Ukraine's merchandise exports, while production decision-making is primarily driven by market forces. At the same time, the structure of Ukraine's industry remains biased towards raw materials and low-value-added products, though the share of investment and high-value-added products has been growing in recent years. Moreover, economic growth was primarily based on utilization of existing capacities while the average accumulated depreciation approached 50%. This signifies that despite the expansion in gross fixed capital formation during the last few years, Ukraine still needs considerable investments to sustain economic growth and meet new challenges related to rising energy prices. This calls for further progress in creating a favorable business environment and accelerating structural reforms.

Ukraine's favorable 2006 performance allows being reasonably optimistic about Ukraine's economic developments in 2007. Although the price for imported gas will increase by another 37% (to $130 per 1,000 m^3), the government expects GDP to grow at 6.5% yoy. However, due to more moderate growth in real household income and further weakening of Ukraine's terms of trade, a real GDP growth rate at about 5% looks more realistic.

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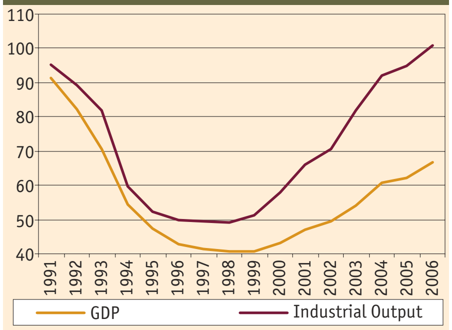
GDP and Industrial Output, 1990=100%

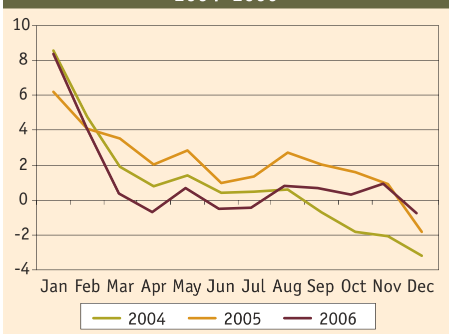


Source: State Statistics Committee

Fiscal Policy

Throughout 2006, successful budget execution raised a number of concerns. Adopted at the end of December 2005, the 2006 budget did not anticipate a price hike in imported energy resources (particularly, natural gas) that occurred at the beginning of the year. Considering also that 2006 was an election year while world steel prices were forecasted to continue weakening, GDP growth at 7% yoy, the rate envisaged in the budget, looked unrealistic. With sluggish privatization and the absence new borrowings, it became clear in the middle of the year that the government may fall short of funds to meet all government liabilities. Though the situation with privatization proceeds did not improve much, reaching only 28.6% of the targeted UAH 2.1 billion ($416 million) in 2006, the government secured deficit financing by resuming domestic and external borrowings in September 2006.

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



Source: Ministry of Finance

Good GDP growth, more moderate increases in recurrent expenditures in 2006 compared to 2005, improvements in the collection of budget revenues introduced in 2005 (particularly elimination of free economic zones) and some below target execution of expenditures allowed the government to maintain a low fiscal deficit. Consolidated budget revenues went up 28% yoy in nominal terms to reach UAH 171.7 billion ($34 billion), while expenditures (including net credits) grew by 23.6% yoy to UAH 175.4 billion ($34.7 billion). As a result, the consolidated budget posted a deficit of 0.7% of GDP, considerably below the originally targeted 2.6% of GDP.

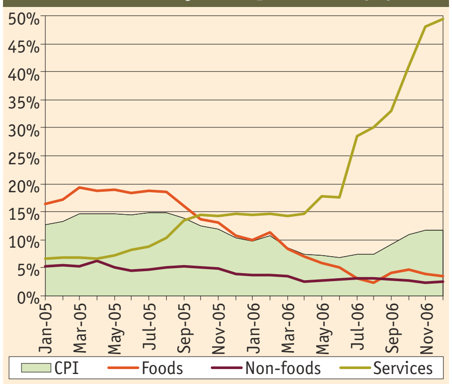
By revenue structure, the collection of VAT was the most dynamic component of fiscal revenues. According to preliminary data, VAT proceeds to the general fund of the state budget grew by about 42% yoy in nominal terms, which was 13% above target. Though the government addressed the problem of VAT refund arrears (in December VAT refunds were over-executed by 47.5%), full-year VAT refunds were under-fulfilled by 5.2%. Improved fiscal performance of enterprises in the second half of the year allowed the planned amount of corporate tax (EPT) revenues to be collected. Just in December, EPT proceeds were over-executed by 31.8%, which was not surprising as enterprises pay the tax on profits achieved during the first eleven months[1] of the year in December. Above-target VAT and EPT receipts compensated for poor collections from excises and export duties. In particular, excises were under-fulfilled by 12.1%, primarily due to poor oil-refining industry performance. Due to high world crude oil prices throughout the year and repairs on several oil-refineries, domestic production of gasoline was displaced by imports. Considerably lower domestic production of gasoline caused export volumes of these commodities to decline, which contributed to under-execution of export duties.

As usual, December saw considerable fiscal loosening. At the same time, despite over-fulfillment of expenditures from the general fund by 12.3% that month, full-year state budget expenditures were almost 6% below target. Unlike the first half of the year when the fiscal deficit was financed by the funds received from the re-sale of metallurgical plant Kryvorizhstal in October 2005, the government actively borrowed from both domestic market and abroad in the second half of the year. Since September when new borrowings were resumed, the government attracted UAH 11.8 billion ($2.34 billion), while the consolidated budget deficit constituted just UAH 3.7 billion ($0.7 billion). Though nominally this resulted in an increase in Ukraine's total public and publicly guaranteed debt to $15 billion at the end of 2006, in GDP terms the debt declined from 17.4% in 2005 to less than 15.5% in 2006. These funds will help to smooth budget execution at the beginning of 2007, taking into account the possible shortfall in budget revenues due to anticipated moderation of household income growth and the likely decline in enterprise profitability due to the 37% price increase on imported natural gas. In addition, the 2007 budget is likely to be amended in the first half of the year, revising upwards the living wage and minimum wage. Moreover, due to the absence of a clear privatization plan as well as the aspirations of the Head of the State Property Fund (an agency in charge of privatization) to keep controlling shares of strategic enterprises (such as telecommunication monopoly Ukrtelecom and Odessa port plant) under state ownership, the ambitious target to receive $2 billion of privatization receipts may be hard to achieve.

Monetary Policy

In 2006, consumer prices grew by 11.6% yoy driven by an energy-price pass-through. In particular, housing and utility tariffs grew by 85.7% yoy; tariffs for railway transportation and communication were up 42.1% yoy and 30.1% yoy, respectively. Soaring real estate prices and utility tariffs caused the cost of rent services to increase by almost 50% yoy. As a result, the index of service tariffs rose by a record high 49.4% yoy. At the same time, 2.2% month-over-month (mom) growth in service tariffs in December suggests that the announced 3.4 times increase in housing and utility tariffs in Kyiv (the capital of Ukraine and the single largest city in terms of resident population and GDP contribution) was not incorporated. A number of court appeals contesting the Kyiv authorities' decision to raise utility tariffs by that much might have been the reason.

CPI and Its Major Components, % yoy



Source: State Statistics Committee, The Bleyzer Foundation

The other components of CPI showed moderate growth in 2006. Robust consumption growth, boosted by considerable social transfers from the budget and loose credit conditions, as well as higher production costs (related to more expensive energy resources, utilities and transportation services) contributed to a food price increase in 2006. However, over-production of some food products (e.g., meat, milk and dairy products, eggs) on the back of unresolved trade relationships with Russia translated into food price deflation during March-August. This helped to contain food price inflation at a modest 3.5% yoy.

Non-food prices were primarily driven by domestic gasoline prices, which in turn followed world crude oil price developments. The acceleration in gasoline price growth during April-September was partly compensated for by deflation in the last three months of the year

[1] This innovation was introduced by the 2006 budget law and prolonged in the 2007 budget law. Before, corporate profit tax for the fourth quarter was paid during the first quarter of the next year.

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as a result of the agreement reached between the government and gasoline traders. Thus, non-food prices reported a modest 2.5% yoy increase over the whole year.

The impact of monetary factors on inflation dynamics was rather limited in 2006, though it slightly increased in recent months following the notable loosening of fiscal policy and large NBU interventions on the interbank forex market. In particular, government cash balances on the account with the NBU declined by 16.2% mom or UAH 3.6 billion ($713 million). Improving export performance and robust capital inflow supplied the market with foreign exchange in an amount considerably exceeding demand. Continuing to maintain a de facto peg of hryvnia exchange rates with respect to the US dollar at 5.05, the NBU intervened on the forex market with net purchases of $530.7 million. This allowed the NBU to replenish its gross international reserves to $22.3 billion, which corresponds to more than 5 months of prospective imports of goods and services. Thus, the monetary base and money supply grew by 10.6% mom and 7% mom in December. However, due to a high base effect, the growth rates declined in annual terms from 53.9% yoy and 54.3% yoy in 2005 to 17.5% yoy and 34.7% yoy in 2006 respectively. In addition, the leveling out of deposit growth (38.8% yoy in 2006 compared to almost 60% yoy in 2005) also contributed to the deceleration of money supply growth.

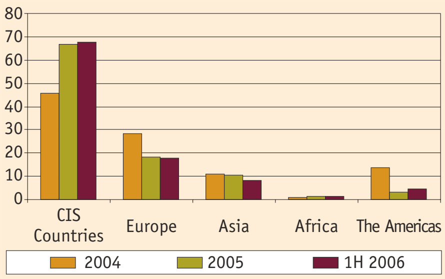
However, despite the flatter growth of the money supply, monetary conditions for commercial banks were rather loose in 2006 as the NBU softened reserve requirements several times and lowered the refinancing rate to 8.5%. Refinancing operations totaled UAH 8.3 billion in 2006. Moreover, commercial banks were active in attracting financial resources from abroad. Thus, for the first nine months of the year, banking sector external debt increased by 55% year-to-date to $9.6 billion. As a result, lending growth continued to strengthen as loans to the real sector and households grew by 71% yoy. Consumer lending has been gaining weight in credit dynamics — loans to households grew by 134.2% yoy in 2006 (up from 126.6% yoy in 2005), bringing their share to 32%. At the same time, on the back of buoyant investment demand, corporate lending expanded by almost 60% yoy, remaining the major contributor to credit growth.

The continuing credit boom with a bias towards foreign currency borrowing raises concerns over rising banking sector vulnerability. In particular, foreign currency loans grew considerably faster than hryvnia-denominated ones (95.4% yoy and 52.4% yoy respectively). As a result, the credit portfolio of commercial banks was almost equally split between hryvnia and foreign currency denominated loans. At the same time, national currency deposits prevail in the structure of commercial banks liabilities. Their share accounted for 62% of total deposits. Though the NBU has already taken several measures to curb robust growth of foreign currency loans, currently it is developing new regulations that would contain more restrictive requirements for granting loans in foreign currency.

International Trade and Capital

In November, merchandise exports growth decelerated to 13.2% yoy (down from 17.9% yoy); however, cumulatively exports increased by 11.4% yoy (up from 11.2% yoy over January-October). The deceleration is primarily attributable to the continuing decline in exports of cereals and mineral products. Following the introduction of export quotas, exports of grain almost ceased in November, declining by 72.2% yoy. As a result, cumulative growth decelerated sharply from 25.7% yoy over January-September to 5.7% yoy for January-November. Exports of mineral products continued to decline, contracting by 17.1% yoy over January-November. The decline was a reflection of poor coke and oil-refining industry performance. At the same time, on the back of industry's output growth rebound beginning in December, export performance of this commodity group may slightly improve in the coming months. On the upside, benefiting from high world steel prices, exports of metallurgical products picked up by 15.9% yoy over the first eleven months of the year. Exports of Ukraine's machinery and vehicles advanced by 16.3% yoy over the period on the back of strong economic growth in CIS countries (the major destination market for Ukraine's export of these commodities).

Geographical Breakdown of Ukraine's Exports of Machinery and Transport Equipment, %

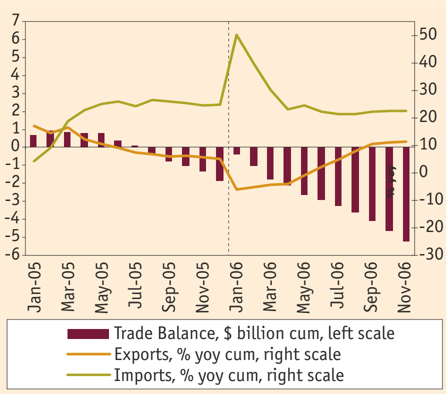


Source: National Bank of Ukraine

Robsut private consumption and investment demand contributed to the growth of imports by 22.4% yoy over January-November. At the same time, merchindise imports continued to decelerate in November, posting a 20.6% yoy increase down from 25.7% yoy in October. The slower imports growth was driven by decelerating imports of mineral products, the weightiest group in total goods imports. Lower world crude oil prices and import volumes of natural gas and crude oil (caused by warm weather conditions and poor coke and oil-refining industry performance, respectively) resulted in just a 8.5% yoy increase in imports of fossil fuels in November with cumulative growth declining to 13.7% yoy. At the same time, vigorous investment demand in the country underpinned imports of machinery and transport equipment, which expanded by 33.2% yoy over January-October.

Despite recent improvements, the FOB/CIF merchandise trade deficit continued widening to reach $5.2 billion (about 5% of estimated full-year GDP). At the same time, due to large surpluses on foreign trade of services and net transfers accounts, the current account deficit is estimated to stay at less than 1% of GDP.

Merchandise Trade Flows in 2005–2006



Source: State Statistics Committee

Other Developments and Reforms Affecting the Investment Climate

In mid-January 2007, the EU and Ukraine signed a new bilateral Steel Agreement, according to which the export quota for Ukraine was increased by 32% to 1.32 million tons and will be eliminated as soon as Ukraine joins the WTO. The new agreement creates additional opportunities for Ukraine's steel industry, which may help the Ukrainian economy to absorb the energy import price hike in 2007.

On January 24th, 2007, an Investment Council under the Cabinet of Ministers was created with the Prime Minister as Head. Though the members of the Council were not announced, it will include representatives of Ukrainian and foreign businesses as well as various government officials. The Council will develop proposals for the formation of the state investment policy, particularly for the elaboration of efficient dialogue between the government and business, and implementation of government investment projects. The Council will also participate in drafting and analysis of legislation related to investment activity. Though the council is defined as an advisory institution, its decisions will be obligatory for state and local authorities' consideration.

Currently, Ukraine is in the process of refining its political system, though it is complicated by the insufficient depth of legislation, which allows for ambiguous interpretation of important provisions built into the Constitution. The situation with the law on the Cabinet of Ministers demonstrates a complex but democratic way of finding compromises between the powers on controversial issues. Eventually, Ukraine will build effective an coordination system between the powers that will enhance the carrying out of structural reforms in the country.

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