# Ukraine
# Macroeconomic Situation



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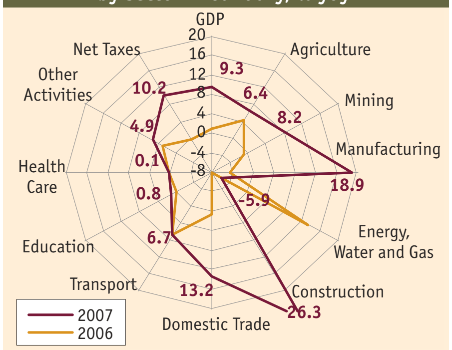
## Summary


- Ukraine started 2007 with impressive economic growth as real GDP grew by 9.3% yoy in January, underpinned by strong expansion in industry and domestic trade.
- On the back of robust economic activity and under-execution of expenditures (typical for the beginning of the year), the consolidated fiscal budget ran a surplus of 8.4% of period GDP.
- Despite considerable fiscal loosening at the end of 2006 and high inflationary expectations, annual consumer inflation decelerated to 10.9% yoy. Though most international and domestic experts expect year-end inflation at around 9.5–10% yoy, the official target of 7.5% yoy may be feasible if the authorities decide to postpone or allow only partial pass-through of energy prices.
- Though in the second half of the year exports recovered from the energy price shock, imports grew at a higher pace, triggered by robust consumption and investment demand in the country. On the back of a wider foreign trade deficit, the current account deficit turned into a small deficit at about 1.5% of GDP in 2006.
- Robust capital inflows covered not only the CA deficit but also helped to replenish the NBU's gross international reserves.
- At the beginning of March 2007, the European Commission launched negotiations on a new Enhanced Agreement between the EU and Ukraine, the integral part of which will be establishment of a free trade area.


## Economic Growth

**Real GDP and Value Added Growth by Sector in January, % yoy**



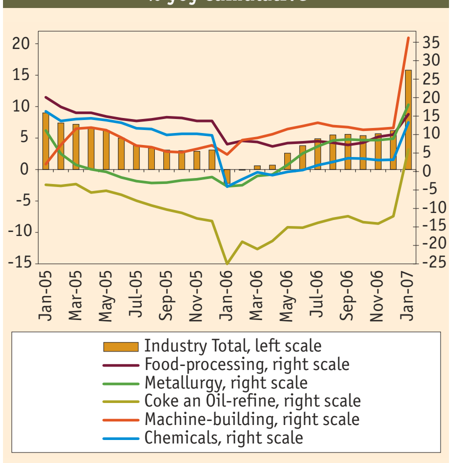

Source: State Statistics Committee

In January, GDP grew by 9.3% yoy, the highest rate ever reported for the beginning of the year. The growth was underpinned by strong expansion of value added in industry, construction, domestic trade and transport. However, high growth rates in these sectors as well as real GDP should be partially attributed to a low statistical base effect. At the beginning of 2006, due to the unanticipated rise in imported energy prices and unfavorable weather conditions, GDP showed modest 0.9% yoy growth on account of the value-added contraction in industry and construction. Though imported gas prices have increased by another 37% to $130 per 1,000 m3 since the beginning of 2007, this shock was anticipated. Robust investment activity in 2006 (according to preliminary estimates, gross fixed capital formation increased by a marked 14.7% yoy) was to a significant extent a business response to the expectations of a further rise in imported energy prices.[1]

January 2007 economic growth was fuelled by buoyant domestic demand and favorable external conditions. Though real household income continued to decelerate, reporting a 12.1% yoy increase in January 2007 compared to 16.1% yoy growth in 2006, private consumption was strong, reinforced by considerable fiscal loosening at the end of 2006 and the continuing credit boom. Robust consumption stimulated domestic-market-oriented sectors and industries, such as wholesale and retail trade (value added was up by 13.2% yoy), transport (up by 6.7% yoy) and the food industry (up by 15.5% yoy).

At the same time, the need to renovate existing capacities and construct new ones as well as to introduce energy-saving technologies spurred investment-driven sectors. Thus, construction reported a 26.3% yoy increase in value added, supported also by unusually warm weather. Machine-building posted a 36.2% yoy increase in output, driven by production of transport vehicles (up by 49.1% yoy), machinery and equipment for the extractive industry and construction (up by 33.2% yoy), metallurgy and agriculture (up by 3.4% yoy and 23% yoy), and home appliances (up by 14.4% yoy).

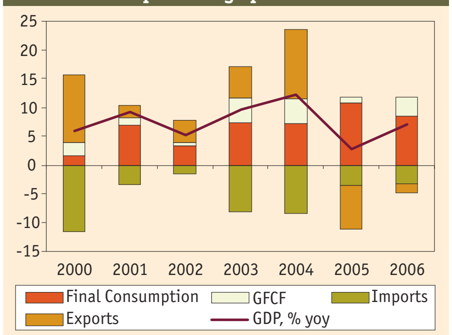
**Industrial Output by Selected Industries, % yoy cumulative**




Source: State Statistics Committee

Since an increase in energy prices at the beginning of 2007 was anticipated, energy-intensive metallurgy and chemicals showed acceleration in output production, benefiting from favorable external conditions. In addition to high world steel prices, the 18.1% yoy increase in metallurgical output in January was closely linked to buoyant growth in machine-building and construction. On the back of strong external demand, chemical production expanded by 13.3% yoy. At the same time, such impressive growth rates are partially attributed to a low base effect. The extractive industry reported 8.2% yoy growth in output, driven by robust demand for metal ores (domestic extraction of metal ores expanded by 13.4% yoy) and domestic energy resources, whose extraction grew by 3.1% yoy. The expansion in machine-building, metallurgy, food, chemical, and extractive industries pushed industrial output growth to 15.8% yoy. On the back of such a remarkable start, the Ministry of Economy upgraded its forecast of industrial output growth to 10.7% yoy for the first quarter of 2007.

**Sources of Economic Growth, 2000–2006, percentage points**




Source: State Statistics Committee, The Bleyzer Foundation

Good economic performance in 2006 (according to recent SSC data, real economic growth in 2006 was revised upwards to 7.1% yoy) and the remarkable start at the beginning of the year allows for optimism about Ukraine's economic developments in 2007. The government expects GDP growth of 6.5% yoy for 2007, which might be realistic under some favorable conditions (i.e., retention of high world steel and chemical prices, strong resilience of the economy to higher energy costs, etc.). However, due to the susceptibility of Ukraine's economic growth to changes in the external environment, projected slower consumption growth and high energy-intensity of industry, we are sticking to a more cautious forecast of GDP growth in the range of 5–6% yoy. Unlike the export-led and consumption-led economic growth in 2000–2004 and 2005–2006 respectively, the expansion in 2007 and beyond will crucially depend on investment activity in the country. Hence, to spur investments in the country, a comprehensive package of government measures aimed at improving the business climate in Ukraine is needed.

## Fiscal Policy

In January, the consolidated budget deficit posted a surplus of UAH 3.7 billion ($730 million), which is equivalent to 8.4% of period GDP. Typical for the beginning of the year, the fiscal surplus was achieved thanks to improved tax collections and under-execution of expenditures. Over the months, consolidated budget revenues reached UAH 12.3 billion ($2.4 billion), which is

[1] Despite a 45% and 37% increase in prices for imported gas at the beginning of 2006 and 2007 respectively, Ukraine's price of $130 per 1000 m3 for imported gas is almost half the average "European" price.





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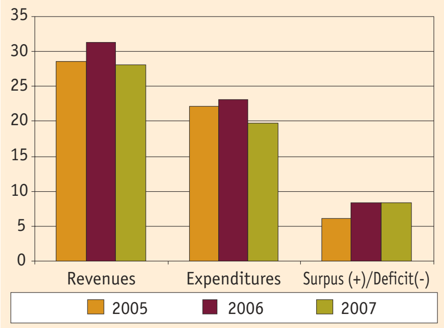
31.5% higher in nominal terms compared to the respective period last year. The growth in revenues was underpinned by a 44.1% yoy nominal increase in tax collections, which were almost 44% yoy higher in nominal terms, while non-tax revenues showed meager growth of 0.5% yoy. Higher tax collections were the result of booming consumption (which is reflected in plentiful VAT proceeds), the high profitability of Ukrainian enterprises despite an increase in energy costs[2], an increase in the income tax rate (from 13% to 15% since the beginning of 2007) and a high base effect. The main reasons for modest growth of non-tax revenues were lower rates of profit transfers to the budget by state-owned enterprises (the rate was reduced from 50% last year to the current 15%) and mandatory duty on purchases of non-cash foreign currency (the rate was reduced to 1% from the previous 1.3%).

**Consolidated Budget Balance in January, % of period GDP**



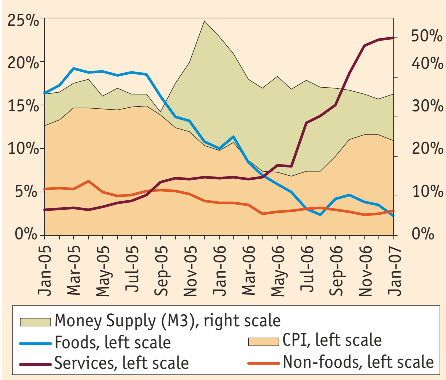

Source: Ministry of Finance

Consolidated budget expenditures, including net credits from the budget, constituted UAH 8.7 billion ($1.7 billion). In particular, expenditures from the general fund of the state budget were executed at 70% of the target. Though the government accumulated significant cash balances on state accounts at the end of the year[3], it followed its usual policy of tightening expenditures at the beginning of the year to alleviate deficit financing risks. In the last three years, such a policy has resulted in considerable fiscal loosening in the last couple of months of the year, contributing to inflation pressures at the beginning of the next year. For 2007, the government targets a state budget deficit at UAH 15.7 billion, or 2.6% of GDP. At the same time, the deficit is likely to be lower as the official forecast of nominal GDP used to develop the 2007 State Budget Law was significantly under-estimated.[4] On the other hand, the budget is very likely to be amended in the coming months as the 2007 budget law contained a provision to revise upwards the minimum subsistence level and minimum wage based on economic and budget performance in the first quarter of 2007. However, during the last two years, the government has proved its commitment to meet and even over-fulfill the deficit targets.

According to the 2007 state budget law, 70% of the targeted fiscal deficit is planned to be financed through privatization proceeds while the rest will be received from new borrowings. In January, privatization proceeds amounted to UAH 91.8 million, which is less than 1% of the target. Though the list of enterprises to be privatized this year totals about 600 enterprises, including state telecom Ukrtelecom, Ukraine's largest ammonia fertilizer producer Odessa port plant, and several regional energy distribution companies (oblenergos), receiving $2.1 billion of privatization receipts may be a challenging task. The major reason is that the government intends to sell minority stakes of the most attractive enterprises (5%-15%), while retaining the controlling stake in the property. In the absence of new public debt borrowings in January 2007, the stock of Ukraine's total public and publicly guaranteed debt declined by 1.4% mom to $15.7 billion, which translates into 12.4% of forecasted full-year GDP.

## Monetary Policy

**CPI and Its Major Components, % yoy**

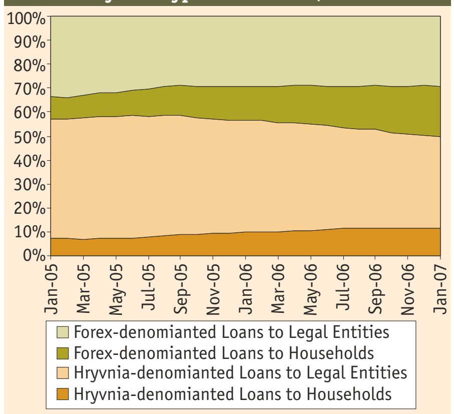



Source: State Statistics Committee, The Bleyzer Foundation

In January 2007, consumer inflation slowed to 0.5% mom despite considerable fiscal loosening at the end of 2006 and high inflationary expectations. In annual terms inflation decelerated to 10.9% yoy, down from 11.6% yoy at the end of 2006. January's unexpectedly low inflation figure indicates that the multiple increases in housing and utility tariffs in Kyiv were again not incorporated due to a number of court appeals and Kyiv authorities' announcements to revise the new tariffs downwards. In addition, the favorable developments were achieved thanks to moderate monetary tightening at the beginning of the year and modest growth of food prices.

Due to overproduction on several food markets (e.g., sugar, meat and meat products, eggs, etc.), prices of food products advanced by a modest 0.4% mom. The non-food price index grew by 0.3% mom, primarily driven by a 1.9% mom increase in gasoline prices (which reflected an increase in world crude oil prices at the end of 2006). In annual terms, both food and non-food price indices were on a moderate track posting 2.2% yoy and 2.8% yoy increases respectively. The government targets consumer inflation at 7.5% yoy for 2007. However, despite the high base effect and better-than-expected inflation performance at the beginning of the year, the year-end inflation is projected at 9.5%-10% yoy due to the rise in energy prices and continuing adjustment of service tariffs to cost-covering levels. At the same time, the government target may be achieved if the authorities decide to postpone or allow only partial pass through of energy prices to consumers.

**Commercial Banks Loans to Private Sector by Currency and Type of Borrower, % of total**




Source: NBU, The Bleyzer Foundation

In 2007, the NBU continued the policy of de facto pegging the hryvnia exchange rate to the US dollar. Since April 2005, the exchange rate has been maintained stable at 5.05 UAH/$. Hence, the monetary policy remains adaptive to changes in government deposits with the NBU and developments on the forex market. In January 2007, the monetary stance was affected by sizable sterilization operations (UAH 6.6 billion), high demand for cash foreign exchange (the balance of net purchases of foreign currency by the population was negative and amounted to $177 million) and accumulation of cash balances on state accounts. At the same time, the NBU's net purchases of foreign currency on the inter-bank market amounted to $223.4 million, thus oppositely affecting developments of monetary aggregates. As a result, the monetary base declined by 1.8% mom in January 2007, which is typical for the beginning of the year. Due to the low statistical base effect, the annual growth rate increased to 26.7% yoy. The money supply (M3) declined by 1.9% mom over the period, reflecting also the reduction of deposits to the banking system by 0.3% mom. In annual terms, the growth rates of money supply and deposits increased to 35.7% yoy and 40.2% yoy respectively.

[2] In January 2007, the share of profitable enterprises increased to 65.6%, up from 61.4% in January last year, while profits were more than 50% yoy higher in nominal terms. Despite the presence of a low base effect, the high profitability of domestic enterprises is closely linked to favorable external conditions and robust domestic demand.

[3] The government targeted the state budget deficit at UAH 13.2 billion ($2.6 billion) for 2006. In light of modest privatization revenues (executed at 26.3% of the target), the government secured enough resources for budget deficit financing through domestic and external borrowing. At the same time, the actual budget deficit constituted only UAH 3.8 billion ($750 million). As a result, cash balances on state accounts amounted to UAH 10.6 billion ($2.1 billion) at the end of the year, according to the Ministry of Finance.

[4] Considering the revised nominal GDP figure for 2006 (UAH 535.9 billion versus UAH 500 billion expected at the 2007 state budget law drafting) and keeping the government forecasts of GDP deflator and real GDP growth for 2007 unchanged, nominal GDP is estimated at UAH 640 billion ($126.7 billion).

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Despite considerable sterilization operations, the liquidity stance of the banking system remained rather loose, which was evident from the low interest rate on interbank credits (below 3% per annum during most of the month). As a result, the stock of commercial bank credits remained almost unchanged compared to the end of 2006, declining by a meager 0.1% mom. At the same time, the demand for bank credit differed considerably among households and legal entities. While commercial bank loans to households grew by 1.8% mom, driven by robust private consumption during the holidays, credits to legal entities declined by 1% mom, which may be explained by lower economic activity that month. By currency structure, the decline in credit volumes was observed just for hryvnia-denominated credits to legal entities whereas forex-denominated credits continued to accelerate, contributing to growing banking sector vulnerability to adverse foreign exchange shocks.

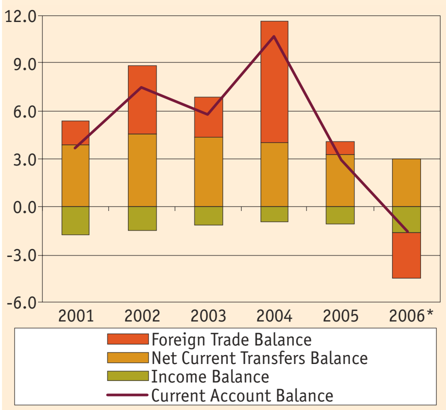
## International Trade and Capital

According to the SSC, merchandise export growth accelerated to almost 17% yoy in December, bringing the cumulative growth rate to 12.1% yoy (up from 11.4% yoy over January-November). The acceleration from the 4.9% yoy increase in exports in 2005 was primarily due to a resumed upward trend of world steel prices in the second quarter of 2006 and their retention at a high level despite some downward correction in the fall of 2006. High world steel prices, as well as robust growth of machine-building and construction, helped metallurgy to absorb the shock of higher production costs (mostly energy and transportation). Exports of ferrous metals posted an increase of 14% yoy in 2006, explaining more than one third of total growth in merchandise exports. Including other metals and metallurgical products, exports of this commodity group explained about 60% of total export growth. Benefiting from robust economic growth in Ukraine's main trading partners (particularly CIS countries), exports of machinery and transport vehicles advanced by 17.3% yoy and 26.3%% yoy respectively, explaining about 23% of total export growth. Export of chemicals was also on the rise (up by 13.4% yoy in 2006) driven by favorable conditions on external markets.

On the downside, mineral products, which traditionally were one of the major exporting items, showed a decline of 17.7% yoy in 2006. The reduction in exports of these commodities is primarily attributed to high prices on world crude oil during the year. Coupled with an increase in production costs, outdated production capacities of Ukraine's oil-refining industry and low import tariffs on oil products, this led to higher-quality imports discouraging domestic production of gasoline and, thus, its export. In addition, merchandise export growth experienced a downward pressure from decelerated exports of cereals and food products. In particular, due to the introduction of grain export quotas in the fall, exports of grain declined by 2.1% yoy in 2006 compared to a 60% yoy increase in the previous year. Exports of food products slowed to 8%, down from 13.2% yoy in 2005, mostly because of Russia's restriction on Ukrainian imports of meat, milk and dairy products.

Continuous expansion of domestic demand, underpinned by real income growth and the credit boom, and the rise in imported gas prices drove imports up by 24.6% yoy. In particular, imports of fossil fuels, the weightiest item in total merchandise imports, expanded by 16.8% yoy in 2006. Despite a 45% increase in the price for imported gas in 2006, imports of natural gas increased by less than 21% yoy, which may be explained by lower volumes of imported gas (due to warm weather in the fall and substitution of natural gas by other fossil fuels (e.g., coal). In addition, the decline in crude oil imports by 4.3% yoy was not fully substituted by oil-products imports. As a result, the share of mineral products in total merchandise imports continued to decline to 30%, down from 32% and 37.4% in 2005 and 2004 respectively. Moreover, the commodity structure of Ukraine's imports revealed a further shift towards investment goods. Imports of machinery and transport vehicles grew about 36% yoy, bringing their share to 29%, up from 26.5% a year before.

**Current Account Performance, 2001–2006**

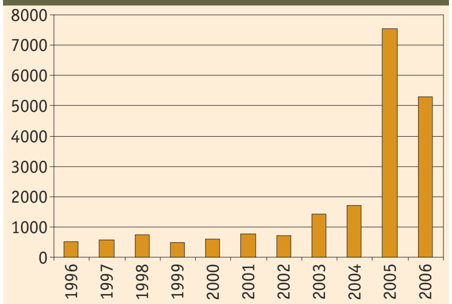



* preliminary data
Source: NBU, The Bleyzer Foundation

Considerably higher growth rates of imports than exports contributed to the growing external imbalances of the country. According to preliminary estimates of the NBU, the FOB/FOB trade deficit reached $4.9 billion, or 4.6% of GDP. Despite the surpluses in foreign trade of services and net transfers accounts, the current account turned into a deficit, which constituted $1.6 billion (or 1.5% of GDP). At the same time, robust capital inflows allowed not only to cover the CA deficit but also to replenish the NBU's gross international reserves. According to preliminary NBU estimates, the net FDI inflow amounted to $5.3 billion, which is almost twice as high as in 2005 excluding receipts from the privatization of metallurgical plant Kryvorizhstal. In addition, external borrowings also grew considerably on account of both private and public sector debt. As a result, NBU reserves reached $22.3 billion at the end of the year, which was equivalent to 4.4 months of future imports of goods and services.

The high dependence on metallurgical exports and energy imports is the main source of Ukraine's economic vulnerability. The weakening of world steel prices on the back of the increasing cost of imported energy is the main risk to Ukraine's foreign trade and economic growth. The 2006 trends in Ukraine's balance of payments are expected to continue in the near future. The merchandise trade deficit will keep widening as imports will be stimulated by robust investment and buoyant (though decelerating) consumption demand. In addition, the increase in prices for imported gas will have a direct effect on imports, raising nominal values. At the same time, we believe the external environment will be favorable enough for the current account deficit to increase moderately to about 3% of GDP in 2007.

**Net FDI inflow, $ million, 1996–2006**




Source: NBU

## Other Developments and Reforms Affecting the Investment Climate

Since the enlargement of the European Union in March 2004, the EU developed the European Neighborhood Policy (ENP) aimed at smoothing the divergence between EU countries and its neighbors. As an integral part of the ENP, the three-year EU-Ukraine Action Plan was jointly approved in February 2005, setting out an agenda of political and economic reforms with short and medium-term priorities. At the same time, the Action Plan and the Partnership and Cooperation Agreement between Ukraine and the EU will expire in March 2008. Ukraine's top government officials repeatedly proclaimed their aspirations to become a member of the EU. However, following the toughening of the entry rules in December 2006, which were adopted as a response to the growing "enlargement fatigue", the EU signaled a slowing down of the pace of enlargement. Though the EU generally supports Ukraine's intention to acquire EU membership, considering the new rules for enlargement, Ukraine's prospects to integrate into the Union in ten-fifteen years are rather uncertain. At the same time, aiming to enhance closer cooperation with Ukraine and promote economic reform, democracy development, strengthen the rule of law and human rights protection, the European Commission launched negotiations on a new Enhanced Agreement between the EU and Ukraine at the beginning of March 2007. The new agreement will include the establishment of a free trade area and will have a special focus on energy security.

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