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.

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.

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 5.5-5.8% 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 (m3) of gas each year at a price $50 per 1000 as a payment for transit of about 125 billion m3 of Russian gas to Europe. The transit fee was set at $1.09 per 1000 m3 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 m3 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 m3 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 hikes 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. 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 increased 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 3.0% 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.

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 apprecia-
tion in April and general cooling of Ukraine's econ-
omy. Imports growth is expected to be high next year
and in the first half of 2006. It is based on rising in-
comes, the anticipated rebound in investment activity
and more expensive energy imports. As steel prices are
forecasted to continue falling next year and a num-
ber 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.

Deterioration of merchandise foreign trade was com-
pensated for by the strong position of Ukraine's for-
eign trade of services. According to the NBU, the
nine-month service trade balance reported a $933 mil-
lion surplus, which is more than 8% yoy higher. Over
the period, the current account surplus shrank by al-
most 63%, however, it remained in surplus of $2.1 bil-
lion, which is equivalent to 0.7% of period GDP. Al-
though the current account will continue to worsen, it
is unlikely to turn into a deficit by the end of the year.

Despite a considerable economic growth slowdown,
Ukraine will post record FDI inflows this year. Al-
though the net FDI inflow was almost 25% yoy lower
in January-September, successful re-privatization of
metallurgical plant Kryvorizhstal and a number of ac-
quisions in the banking sector will boost FDI to a re-
cord 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 total-
ing $290 million. The Bank plans to allocate $150 mil-
ion to improving the rural population and municipali-
ties’ access to financial services. The other project is
designed to provide loans to local governments and
utilities for priority investments in improving infra-
structure (water supply, waste-processing systems,
etc.) In mid-November, another $99.4 billion project
started aimed at modernization of the social assis-
tance system.

In mid-December, the European Bank for Reconstruc-
tion 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 bi-
lion is reserved for SigmaBleyzer's Southeast Euro-
pean Fund IV.

Other Developments and Reforms

Affecting the Investment Climate

On November 26th, the parliamentary election cam-
paign officially started in Ukraine. 52 political parties
and blocks expressed the intent to participate in the elec-
tions. For the first time, elections will be held on a pro-
portional vote system replacing the mixed (propor-
tional-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.
Yanukovych, the former rival of President Yushchenko
during the presidential elections last year, holds the lead-
ing 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 Consti-
tution of Ukraine will be partially enforced, although a
number of important provisions will be fully effective af-
after the parliamentary elections on March 26. The consti-
tutional reform envisages a shift to a parliamentary-pres-
idential republic, reducing presidential power and giv-
ing more authority to the Parliament. In particular, the
power of the President of Ukraine is limited to the ap-
pointment of the Prime Minister upon the formation of a
majority coalition in the Parliament, and the appoint-
ment of the Minister of Defense, the Minister of Foreign
Affairs, the Head of the National Bank, and the Prosecu-
tor General with the subsequent approval of the Parlia-
ment. However, the President will have the right to dis-
solve the Parliament if it fails to form a majority coal-
ition 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 dis-
solution, the Cabinet of Ministries will also be automati-
cally 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.