Summary

- Despite early concerns about Ukraine's economic situation in 2005, the country ended the year with a relatively good performance overall.
- In 2005, gross domestic product (GDP) grew by 2.4% year-over-year (yoy); the deceleration from the previous year was primarily due to a high base effect, unfavorable external conditions and a reduction in public investments.
- Fiscal performance in 2005 was better than expected at the beginning of the year. Despite sizable increases in fiscal expenditures, the record high growth of budget revenues allowed for a year-end fiscal budget with a reasonable 2% of GDP deficit, in accordance with IMF recommendations.
- Year-end consumer inflation decelerated to 10.3% yoy, lower than initially expected.
- Despite the deteriorating merchandise foreign trade balance, the current account showed a reasonable 2.7% of GDP surplus due to strong services foreign trade.
- The impact of the recent gas price increase on the Ukrainian economy, though significant, will not be as damaging as initially projected.
- International rating agencies kept Ukraine's ratings unchanged but expressed some concerns.

Economic Growth

According to preliminary data, GDP grew by 2.4% yoy in 2005, underpinned by strong private consumption growth. For the first nine months of 2005, private consumption increased by a real 17% yoy (up from 15.7% yoy in the respective period last year), stimulated by sizable social payments and easier access to bank credits. At the same time, robust domestic demand stimulated imports, which increased by a real 3.3% yoy over the period, while exports declined sharply by 10.5% yoy negatively affected by April’s national currency appreciation and unfavorable external conditions. Political turbulence at the end of 2004/beginning of 2005 and several controversial measures by the new government (such as re-privatization, attempts to introduce price regulations) may have affected investor sentiment and caused a temporary delay in investment projects. However, we believe that the decline in gross fixed capital formation by a real 1% yoy during the first nine months of the year was primarily due to a cut in public investments. In 2004, investments in fixed capital financed from state and local budgets almost doubled in nominal terms compared to the previous year, representing a very high base for comparison. The revision of the state budget at the beginning of 2005 envisaging a further increase in social payments and large profit deductions by state-owned enterprises may have resulted in sharp decline of public investments. Thus, unfavorable external conditions, a high base effect and sluggish investment activity were the major reasons of the GDP growth deceleration in 2005.

On the supply side, 2005 GDP growth was driven by fairly good performance in the transportation sector, the extractive industry and manufacturing. During December, growth in these sectors accelerated, bringing the cumulative growth rates to 8.1%, 4.4% and 3% yoy, respectively. The decline in wholesale trade and construction and a considerable slowdown in the industrial sector were responsible for economic growth deceleration in 2005. In particular, value added in wholesale and retail trade (accounting for about 12% of GDP) declined by 8.3% yoy according to preliminary data. Poor wholesale trade performance may be attributed to deceleration in domestically-oriented industries, a reduction in the number of trade mediators and a decline in exports. Construction reported a 6.6% yoy decline in value added, affected by sluggish investment activity. Despite a good harvest this year, value added in agriculture grew by 0.8% yoy in 2005. The deceleration compared to the previous year may be attributed to a high base effect and negative developments in cattle breeding during 2005 (reduction in cattle stock and milk production.)

In December, industrial output growth accelerated to 5.3% yoy, bringing the cumulative growth to 3.1% yoy. The deceleration from an impressive 12.5% yoy in 2004 was due to the slowdown in manufacturing to 3% yoy in 2005 (down from 14.6% yoy last year.) The main industries that drove down manufacturing production were metallurgy and machine-building. In October, metallurgical production rebounded and accelerated to 5.3% yoy in December, which may be attributed to considerable deceleration in the decline of world steel prices in the last four months of the year. However, this was not enough to compensate for considerable deterioration in the previous months; thus for the whole year metallurgy reported a 1.5% yoy decline in output. Machine-building production continued to pick up, expanding by 17.2% yoy in December. Considerable acceleration in the last two months of the year may be attributed to revived external demand for aerospace and military machine-building products. Cumulatively, however, machine-building production decelerated to 7.1% yoy in 2005, down from the explosive 28% yoy in 2004. On the upside, benefiting from strong domestic and external demand, food processing advanced by 13.7% yoy in 2005, up from 12.4% yoy in 2004.

According to the agreement between Ukraine and Russia on January 4th 2006, the new price of imported 34 billion m3 gas to Ukraine will be $59 per 1000 m3 at the Russian-Ukrainian border as of the beginning of 2006. This is a significant increase from $50 per 1000 m3 for Russian gas in 2005. At the same time, it will be partially covered by a 47% increase in the transit fee to $1.6 per 1000 m3 100 km. In 2006, Ukraine also plans to get about 22 billion m3 of Turkmen gas under a separate contract at an average price of $55 per 1000 m3, which means approximately $90 per 1000 m3 at the Ukrainian border. Since the cost of Turkmen gas was about $65 per 1000 m3 at the Ukrainian border in 2005, the average price increase of total imported gas is estimated at about 42% yoy. As a result of our analysis, the impact of the gas price increase on the Ukrainian economy, though significant, will not be as damag-
In 2005, consolidated budget expenditures increased by a nominal 40% yoy to UAH 141.5 billion ($28 bil-
lion), the lion’s share of which was directed to finance generous social programs. According to the budget
amended at the beginning of 2005, the government not only maintained social obligations made in the
run-up to the presidential election in the fall 2004 but even increased them. In particular, minimum wage
and pension were increased by 40% and 16.5% respect-
ively in 2005, while the average pension was raised
by 28% yoy. The other social benefits (such as bene-
fits for childbirth, disability, etc.) were also substi-
tially increased. As a result, budget expenditures rep-
resented about 34% of estimated 2005 GDP, up from
29.4% of GDP in 2004.

At the same time, budget revenues increased by an im-
pressive 46.5% yoy to UAH 134 billion ($26.5 bil-
lion). In 2004, budget revenues grew by about 21% yoy and were supported by impressive GDP growth at
12.1% yoy. The government estimates regarding a
substantial budget revenues increase (which were con-
sidered very ambitious at the beginning of the year)
materialized due to elimination of a number of tax
privileges and exemptions, including those to free eco-
nomic zones, larger profit transfers by state-owned en-
terprises, de-shadowing of the economy, advance pay-
ments of enterprise profit tax and some accumulation
of VAT refund arrears. As a result, consolidated bud-
get revenues as a percent of estimated 2005 GDP in-
creased to a record high 32% (for comparison, the re-
spective ratios were 26.5% and 28.2% of GDP in 2004
and 2003, respectively.)

In 2005, the government financed the fiscal deficit pri-
marily through privatization receipts, which were at a
record high level due to the successful privatization
of Kryvorizhstal (later renamed Mittal Steel Kryvyj Rih). Although Ukraine issued new debt instruments
in 2005, the funds were predominantly directed to re-
duce the cost of previous borrowings. As a result, the
stock of public debt declined by about 4% yoy (8.5%
yoy if expressed in national currency) to UAH 15.5 billion
at the end of 2005, or about 18.8% of estimated GDP.
In particular, external public debt declined to $11.7
billion, or about 14.3% of estimated GDP. At the
same time, due to continuing growth of external pri-
vate debt by more than 66% yoy at the end of Septem-
ber 2005, total external debt advanced by 18.7% since
the beginning of the year to $23.3 billion, or 28.5% of
estimated full-year GDP. Although this rate is among
the lowest in Central and Eastern European countries,
r rapid growth of external private debt raises concerns.

In 2005, consumer inflation reached 10.3% yoy, decel-
erating from 12.3% yoy a year before. At the begin-
ing of 2005, inflationary pressures were generated by
considerable fiscal loosening in the fall of 2004 and
political uncertainties at the end of 2004/begin-
ning of 2005. During the second and third quarters, in-
flation was primarily driven by a number of supply
side shocks (such as an increase in world crude oil
prices, shortages of meat and sugar) and an increase
in utility tariffs. Administration intervention in price
setting mechanisms for particular goods was gener-
ally inefficient but lessened tensions on the respective
markets. The deceleration in the fall should be primar-
ily attributed to a high base effect and absorption of
supply side shocks helped by stabilization of world
crude oil prices, reduction of import tariffs, etc. Con-
sumer inflation also benefited from the decreasing
pressure from producer prices. In 2005, the producer
price index (PPI) decelerated to 9.5% yoy, down from
24.2% yoy last year.

Food prices, which account for about 65% of the consumer
basket, became 10.7% more expensive in 2005. Considerable
deceleration in December (down from 13.2% yoy in the month before) was mainly due to a
high base effect. Food prices were affected by expan-
sionary fiscal policy, which encouraged consumption
particularly by lower income groups (thus shorted
translated into higher demand for foods), and supply
side shocks. Despite a 24.5% yoy increase in gaso-
iline prices in 2005, the non-food price index was mainly on a
declining trend, reporting a 4% yoy increase for the
whole year. However, high gasoline prices af-
fected transportation tariffs, which surged by 25.5%
yoy. Coupled with a 13.6% yoy increase in the cost of
public utilities, service tariffs reported 15.8% growth,
almost twice as high as in 2004.

Before the gas dispute, the government forecasted in-
flation to decline to 8.7% yoy in 2006, although inter-
national and domestic experts were more cautious,
forecasting inflation at about 10% yoy. High oil
prices in 2005 may continue to pressure inflation in
2006 as a spillover effect on other prices. The in-
crease in the price for imported gas will also pressure
transportation and utility tariffs. Although the deci-
sion to raise gas and electricity tariffs for households
from the beginning of 2006 was abolished, they will
most likely be raised after March’s parliament elec-
tions. In addition, loose fiscal policy in 2006 will add
to inflationary pressures. As a result, we believe con-
sumer inflation will be in the range of 13-14% yoy at
the end of 2006.

At the same time, inflation could have been much
higher in 2005 if the NBU did not appreciate the na-
tional currency by about 4.8% in mid-April 2005. The
appreciation reduced the cost of imported goods and re-
strained the growth of monetary aggregates. At the
same time, uncertainties related to the forthcoming par-
liamentary elections and the gas issue resulted in depre-
ciation pressures at the beginning of 2006. In particu-
lar, the cash exchange rate depreciated to an average
UAH/$5.56 in mid-January. However, the official ex-
change rate was kept unchanged at UAH/$5.05, though
the central bank had to intervene on the foreign
market to maintain it by selling about $800 million of
its international reserves. Most likely, in order to calm
inflationary pressures and the speculative tone of the
foreign exchange market, the NBU will maintain ex-
change rate stability at least during the first half of the
year. Nevertheless, to avoid an abrupt drop in interna-
tional reserves, the exchange rate will be allowed to
gradually depreciate to about UAH/$5.2.

In 2005, monetary policy did not change substantially
from the previous year. The accommodative mone-
tary policy was aimed at lessening inflationary pres-
ures generated by sizable foreign exchange interven-
tions and vigorous consumption growth (stimulated
by rapid expansion of bank loans to the private sector,
among other things.) In particular, the NBU tightened
reserve requirements to commercial banks several
times during the year, increased its refinancing rate to
9.5%, and sterilized commercial bank liquidity in the
amount of UAH 17.2 billion ($3.4 billion). During
January-October, the average growth rates of the mon-
etary base and money supply were 35.5% and 36.4%
yoY, respectively. However, by the end of the year,
the growth of the respective aggregates sped up to
39.9% and 44.8% yoy. The acceleration in the last
two months of the year may be attributed to the low
base effect and considerable fiscal loosening at the
end of the year.

International Trade and Capital

In November, Ukraine's merchandise foreign trade con-
tinued to deteriorate. For the second time this year, ex-
ports reported a decline, contracting by 0.2% yoy. At
the same time, imports grew by almost 19% yoy. Cumula-
tively, imports grew much faster than exports (up by
24.6% yoy and 5.6% yoy, respectively). As a result, the
cumulative trade deficit reached $1.34 billion at the end
of November. Robust growth of imports this year
should be attributed to import liberalization (in particu-
lar, reduction of a number of import tariffs and simplifi-
cation of customs procedures), vigorous domestic de-
mand and high world crude oil prices. In addition, the
launch of an extensive anti-smuggling campaign aimed
at legalizing "grey imports" may also contributed to the
growth of imports. At the same time, sharp exports decel-
eration is associated with weakening of external demand
for Ukrainian metallurgical products, higher production
costs (mainly due to the increase in cargo transportation
tariffs) and national currency appreciation. The men-
tioned factors eventually resulted in a current account
deficit of $200 million in the third quarter of the year,
though cumulatively it remained in surplus due to large
positive balances generated in the first half of the year.
According to preliminary estimates, the current account
balance was still positive at about $2.2 billion (or 2.7% of
estimated 2006 GDP) at the end of the year, but the
surplus was more than three times narrower than last
year.

By product breakdown, the growth of metals exports
decelerated to 10.7% yoy for the period, down from
more than a 50% yoy increase in 2004. The deceleration
was due to declining world steel prices caused by the
introduction of China's new metallurgical capaci-
ties. At the same time, metals remained the largest
contributor to Ukraine's merchandise exports growth
as the industry accounted for about 41.5% of total ex-
ports. To a large extent, however, the declining trend
of exports growth should be attributed to drastic deter-
rioration in exports of machinery and equipment.

Since the beginning of the year, exports of these com-
modities declined by almost 8% yoy in contrast to the
impressive 10.4% yoy increase in 2004. On the im-
port side, energy resources (the weightiest item in to-
tal merchandise imports) decelerated to 7.2% yoy
(down from 8.6% yoy over January-October), thus ex-
plaining the declining trend of total imports growth.

The recent increase in imported gas prices will sub-
stantially affect Ukraine's foreign trade performance in
2006. The most significant effect the increase will be
felt by export-oriented industries such as metal-
lurgy and chemicals, which together account for more
than 50% of Ukraine's total exports. Although it is
very likely that the profitability of metallurgical com-
panies will decline considerably while the chemical
enterprises will find themselves on the edge of profit-
ability, the impact of the gas price increase will be
lessened by relatively high international prices on
these commodities. In particular, although world steel
prices are forecasted to continue to decline in 2006,
the trend will be much flatter than in 2005 and world
steel prices will be considerably higher than in 2003.
World prices for chemical products are forecasted to
increase slightly. On the import side, the gas price in-
crease will result in a worsening merchandise foreign
trade balance, which will be partially covered by a
larger surplus in foreign trade of services due to in-
creased transportation tariffs. Therefore, the current
account will run a deficit, though a rather small one at
about 1% of forecasted 2006 GDP.

Other Developments and Reforms

Affecting the Investment Climate

In mid-January, the major international agencies —
Fitch and S&P — affirmed Ukraine's long-term for-
ieg and local currency ratings, though Fitch changed
the outlook from Positive to Stable. The major reason
for keeping the ratings unchanged in spite of the chal-
enges (related to GDP growth deceleration in 2005,
the impact of the imported gas price increase on eco-
nomic growth and political uncertainties) was low
public and external debt ratios, the central bank's high
international reserves and the rather modest current
account deficit forecasted for 2006.