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.

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

Fiscal Policy

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.
Macroeconomic Situation

November 2006

Foreign Currency Loans

In October, 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 NBUs 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 monetary base 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.

Decent growth of deposits (up by 41.8% yoy in October), the NBUs 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 accelerated 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 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.

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ing their share to 48.5% at the end of October compared with about 43% at the beginning of the year.

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.

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.