



Vasily Astrov

Ukraine: a new WTO member

WTO accession paving way for free trade negotiations with the EU

On 16 May 2008, Ukraine officially became a member of the World Trade Organization. This move should have a number of consequences for the country's economy. According to the terms of accession, the binding import tariffs¹ on agricultural products were lowered by about 3.5 percentage points to 10.66% on (unweighted) average, with the highest tariffs applying to sugar (50%)² and sunflower seed oil (30%). For industrial goods, the average binding import tariff has been set at 4.95%; however, in effective terms, a reduction of tariffs may not necessarily take place, given that the WTO-conform tariff regime for industrial goods were implemented already in 2005. On the export side, export duties (such as for metals scrap, oilseeds and grain) will be gradually reduced, and export quotas eliminated. Also, the import quota for Ukrainian steel in the EU has been scrapped, and the import tariffs in WTO member countries applied to Ukrainian goods were reduced to the MFN ('most-favoured-nation') regime levels. In the case of the EU, however, no automatic tariff reduction has taken place, since MFN tariffs were being applied within the framework of the Partnership and Cooperation Agreement already before. Finally, the incidence of anti-dumping measures against imports from Ukraine (such as chemicals) should go down substantially, as the country will get access to WTO trade dispute facilities. Thus, metals and chemicals are likely to be the two sectors of the economy benefiting most from WTO accession.

Probably more importantly, judging from the earlier experience of other countries, WTO membership should further improve the climate for FDI, particularly into the country's still largely inefficient and energy-intensive industrial sector. Overall, Ukraine is offering a lucrative combination of a highly qualified and still cheap workforce, proximity to EU markets and good market prospects both at home and in Russia. Last but not least, WTO accession clears the way for the formation of a free trade area with the EU (the negotiations on this have already started). However, for that, a number of difficult issues will have to be settled, most notably the compatibility with Ukraine's largely free trade regime with Russia and other CIS countries.

¹ According to the WTO regulations, the actually applied import tariffs may not exceed the so-called 'binding' tariffs agreed upon accession.

² At the same time, a tariff quota on raw sugar (260 thousand tons at 2%) has been set and will be raised subsequently.

Household consumption gains momentum

Well in line with our earlier predictions, the impact of the global economic slowdown and financial turmoil on the Ukrainian economy has proved to be small, at least so far. In January-May, GDP went up by 6.4%, driven – as before – primarily by the strong domestic demand. Industrial output grew by 8%, with machinery doing particularly well (+31.1%), largely on account of surging car production. At the same time, the metals industry was nearly stagnant – notwithstanding the favourable world price dynamics.

The retail trade turnover – a proxy for private consumption – soared by 30.2% in real terms, and trade as a whole (including wholesale trade) recorded the highest growth in real value-added across all main economic sectors (+15.3% in January-April). The consumption boom is underpinned by a strong pick-up in disposable households incomes (+17.7% in real terms in January-April), although the growth of real wages proved to be much more modest (+11.9%) and has been decelerating. Instead, generous social payments played a decisive role, as did the USD 1 billion worth (so far) government compensation of private deposits in the former Soviet Sberbank, which had been eaten away by hyperinflation during the 1990s.³ According to a government resolution adopted in March, pensions were raised to the subsistence minimum, while the introduction of targeted – as opposed to undifferentiated – social assistance starting from 1 May has been postponed. Finally, access to household credit has hardly tightened (more on that, see below).

By contrast, investment expansion has slowed down markedly. In the first quarter, gross fixed investment increased by a relatively modest 10.4% (compared to 32.2% in the first quarter of 2007), whereas in metallurgy investments even fell. Another indicator of the relatively weak investment activity have been the declining construction volumes (by 1.1% in January-May). The slowdown in industrial investments under the second government of Yulia Tymoshenko may not come as a surprise given the earlier experience from the time of her first premiership in 2005, even if this time her policies are generally more balanced and arguably less controversial.

Rising inflation puts downward pressure on real interest rates

Despite the global financial turmoil and the marked fall of the Ukrainian stock market,⁴ financial stability has been generally preserved. At the end of April, outstanding credits of the banking sector were some 75% higher than the year before (although credit growth decelerated somewhat in April). Some of the country's biggest banks which are foreign-owned have enjoyed access to the funds of their parent companies, although many of the domestically owned smaller banks are reportedly facing difficulties to re-finance themselves. Between January and May, lending rates in hryvnia indeed rose by about 3.5 percentage points (to 17.5% in average weighted terms). However, over the same period, consumer price inflation surged by more than 10 percentage points (to 31.1%), implying that in real terms, interest rates became even more negative. The latter holds true even

³ These compensations take place with a generally flat fee of USD 200 per depositor.

⁴ After reaching its peak in mid-January 2008, over the following five months Ukraine's PFTS stock index lost 32% of its value.

more for loans denominated in foreign currencies (US dollar and euro): the nominal interest rates charged on them are lower than for hryvnia-denominated loans, whereas the exchange rate outlook is rather stable: if anything, the hryvnia will rather appreciate.

As has been the case last year, the rising inflation is explained first of all by the soaring prices of food (+50.5% in May 2008 year-on-year), notably fruit (+84.9%), oils and fats (+83.2%), and vegetables (+80.9%).⁵ One 'cost-push' factor behind the rising inflation is represented by the rising wages, particularly in the public sector. On average, official nominal wages in April 2008 were 41.7% higher than a year earlier – far ahead of labour productivity. At the same time, the surge in food prices has little to do with domestic 'overheating' but rather reflects global trends: the speculative demand for the key food commodities and the increased use of crops for biofuels production. Nevertheless, the poor grain harvest in Ukraine last year played a role as well. This year, the harvest is expected to be good (up to 40 million tons of grain), which will almost certainly mitigate inflationary pressures, at least over the summer months. In contrast, the restrictive steps undertaken by the National Bank – the tightening of capital adequacy requirements in February and the two successive hikes in the refinancing rate, to 12% p.a. by the end of April – seem to have had very limited effect, which is hardly surprising against the background of the fixed exchange rate regime (against the US dollar) and Ukraine's high degree of capital market integration, meaning that the money supply is largely determined by flows of foreign exchange.

Hryvnia revalued against the US dollar

The booming domestic demand causes the country's external position to deteriorate still further. In the first quarter of 2008, the current account deficit reached as much as 9.6% of GDP (after 4.2% in 2007 as a whole), reflecting first of all the booming goods imports. According to the customs statistics, in January-April 2008, goods exports increased by 30.9% in US dollar terms year-on-year – far below the growth of registered imports (+50.3%), although the latter can be partly attributed to the current anti-smuggling campaign.

Despite the widening external deficits, the abundant capital inflows have exerted strong appreciation pressure on the hryvnia. Starting from April, the National Bank was increasingly reluctant to defend the peg of UAH 5.05 to the US dollar, which had been maintained for the past three years. As a result, the hryvnia was persistently appreciating in the interbank market (to UAH 4.55 per US dollar by 21 May), ultimately prompting the National Bank to revise the official exchange rate to a new peg of UAH 4.85 per US dollar, implying a 4% nominal revaluation. Given the modest scale of revaluation and the global weakness of the US dollar, the move itself is unlikely to hamper the country's external competitiveness in a serious way. Other factors such as domestic wage pressures and the rising price of imported energy may potentially play a far greater role, although at the

⁵ The high weight of foodstuffs (55%) in the consumer basket underlying CPI calculations may, however, be exaggerated as it is derived from household surveys, which tend to capture primarily the poorer segments of the population, spending relatively more on food. Therefore, the 'true' inflation rate may be somewhat lower than suggested by official statistics.

moment, they are to a large degree offset by the favourable terms of trade (first of all high export prices for steel, chemicals and agricultural products).

Yushchenko-Tymoshenko coalition loses majority

Well in line with our earlier forecast, the continuation of economic growth in excess of 6% in 2008 appears likely given the ongoing fiscal expansion, the availability of credit and – last but not least – the expected good harvest. At the same time, the forecasts for inflation and the current account deficit this year had to be revised upwards. Next year, a GDP growth slowdown may follow, after the effects of the current fiscal impulse have died down, and with the level of private indebtedness possibly approaching unsustainable levels. Also, any major downturn in global steel prices (which may result e.g. from a recovery of the US dollar) remains a risk factor. By contrast, a more vibrant investment activity – conceivable in the case of a change of government – would obviously help economic growth.

A departure of the Tymoshenko government might result from the recent loss of absolute majority in the parliament by the ruling coalition between her party (BYuT) and the party of President Yushchenko (OUPS). This event was the culmination of the mounting tensions between Ms Tymoshenko and Mr Yushchenko, which manifested themselves *inter alia* in the lengthy struggle over the control of the State Property Fund (with pro-presidential forces successfully undermining the government privatization plans) and in controversies over the planned constitutional reform (with Mr Yushchenko seeking to strengthen presidential power and Ms Tymoshenko aspiring for the opposite). Also, the government has revoked a major oil production-sharing agreement (PSA) with the US-based Vanco signed under the former government and with the approval of the president. The latter move is aimed at confirming Ms Tymoshenko's image as a fighter against 'oligarchs' and corruption who safeguards the country's 'national interests' (the insufficient transparency of the Vanco deal and its alleged ties to Russia's Gazprom were the official reasons for the PSA revocation). Irrespective of how long her government will hold, Ms Tymoshenko is currently one of the two main contenders for the presidential elections scheduled for the end of 2009 (along with the opposition leader Viktor Yanukovich), with the incumbent president Yushchenko being an outsider.

Table UA

Ukraine: Selected Economic Indicators

| | 2004 | 2005 | 2006 | 2007 ¹⁾ | 2007 1st quarter | 2008 | 2008 Forecast | 2009 Forecast | 2010 Forecast |
|--|---------|---------|---------|--------------------|---------------------|--------|------------------|------------------|------------------|
| Population, th pers., end of period | 47281 | 46930 | 46646 | 46373 | 46560 | 46287 | 46000 | 45800 | 45600 |
| Gross domestic product, UAH mn, nom. | 345113 | 441452 | 544153 | 712945 | 137648 | 189768 | 896000 | 1082700 | 1262400 |
| annual change in % (real) | 12.1 | 2.7 | 7.3 | 7.6 | 8.9 | 6.0 | 6.5 | 6 | 6 |
| GDP/capita (EUR at exchange rate) | 1100 | 1467 | 1836 | 2216 | . | . | . | . | . |
| GDP/capita (EUR at PPP - wiiw) | 4460 | 4720 | 5220 | 5800 | . | . | . | . | . |
| Gross industrial production | | | | | | | | | |
| annual change in % (real) | 12.5 | 3.1 | 6.2 | 10.2 | 12.5 | 7.8 | 8 | 8 | 8 |
| Gross agricultural production | | | | | | | | | |
| annual change in % (real) | 19.7 | 0.1 | 2.5 | -5.6 | 5.0 | 0.2 | . | . | . |
| Construction output total | | | | | | | | | |
| annual change in % (real) | 17.2 | -6.6 | 9.9 | 15.8 | 16.5 | 1.7 | . | . | . |
| Consumption of households, UAH mn, nom. | 180956 | 252624 | 319383 | 422837 | 86385 | . | . | . | . |
| annual change in % (real) | 13.5 | 16.6 | 15.9 | 17.1 | 19.1 | . | 20 | 15 | 12 |
| Gross fixed capital form., UAH mn, nom. | 77820 | 96965 | 133874 | 195179 | 32931 | . | . | . | . |
| annual change in % (real) | 20.5 | 3.9 | 21.2 | 24.8 | 25.9 | . | 10 | 20 | 20 |
| LFS - employed persons, th, avg. | 20295.7 | 20680.0 | 20730.4 | 20904.7 | 20537.2 | . | . | . | . |
| annual change in % | 0.7 | 1.9 | 0.2 | 0.8 | 0.5 | . | . | . | . |
| Reg. employees in industry, th pers., avg. ²⁾ | 3408.3 | 3415.8 | 3361.9 | 3278.8 | 3303.3 | 3246.6 | . | . | . |
| annual change in % | -0.2 | 0.2 | -1.6 | -2.5 | -2.2 | -1.7 | . | . | . |
| LFS - unemployed, th pers., average | 1906.7 | 1600.8 | 1515.0 | 1417.6 | 1633.8 | . | . | . | . |
| LFS - unemployment rate in %, average | 8.6 | 7.2 | 6.8 | 6.4 | 7.4 | . | 6.4 | 6.6 | 6.8 |
| Reg. unemployment rate in %, end of period | 3.5 | 3.1 | 2.7 | 2.3 | 2.8 | 2.3 | . | . | . |
| Average gross monthly wages, UAH ²⁾ | 589.6 | 806.2 | 1041.4 | 1351 | 1161.0 | 1619.0 | . | . | . |
| annual change in % (real, gross) | 17.0 | 20.4 | 18.4 | 15.0 | 14.7 | 13.8 | . | . | . |
| Consumer prices, % p.a. | 9.0 | 13.5 | 9.1 | 12.8 | 10.2 | 22.5 | 18 | 14 | 10 |
| Producer prices in industry, % p.a. | 20.5 | 16.7 | 9.6 | 19.5 | 16.6 | 26.9 | . | . | . |
| General government budget, nat. def., % GDP | | | | | | | | | |
| Revenues | 26.5 | 30.4 | 31.6 | 30.8 | 32.0 | 32.5 | . | . | . |
| Expenditures ³⁾ | 29.7 | 32.2 | 32.3 | 31.9 | 27.4 | 29.5 | . | . | . |
| Deficit (-) / surplus (+), % GDP | -3.2 | -1.8 | -0.7 | -1.1 | 4.6 | 3.0 | . | . | . |
| Public debt in % of GDP | 24.7 | 17.7 | 14.8 | 12.5 | . | . | . | . | . |
| Refinancing rate of NB % p.a., end of period | 9.0 | 9.5 | 8.5 | 8.0 | 8.5 | 10.0 | . | . | . |
| Current account, EUR mn ⁴⁾ | 5560 | 2030 | -1289 | -4320 | -921 | -2418 | -7000 | -8500 | -10000 |
| Current account in % of GDP | 10.6 | 2.9 | -1.5 | -4.2 | -4.4 | -9.6 | -6.3 | -5.8 | -5.3 |
| Gross reserves of NB excl. gold, EUR mn | 6977 | 16058 | 16587 | 21634 | 16814 | 20535 | . | . | . |
| Gross external debt, EUR mn | 22528 | 33504 | 41391 | 57529 | 44758 | 58551 | . | . | . |
| Gross external debt in % of GDP | 47.1 | 45.3 | 50.6 | 59.9 | . | . | . | . | . |
| FDI inflow, EUR mn ⁴⁾ | 1380 | 6263 | 4467 | 7220 | 1309 | 1853 | 7000 | . | . |
| FDI outflow, EUR mn ⁴⁾ | 3 | 221 | -106 | 491 | 5 | 107 | 500 | . | . |
| Exports of goods, BOP, EUR mn ⁴⁾ | 26906 | 28093 | 31048 | 36383 | 8279 | 9312 | 40000 | 44000 | 48000 |
| annual growth rate in % | 28.0 | 4.4 | 10.5 | 17.2 | 21.3 | 12.5 | 10 | 10 | 9 |
| Imports of goods, BOP, EUR mn ⁴⁾ | 23895 | 29004 | 35188 | 42900 | 9603 | 12199 | 50000 | 56000 | 62000 |
| annual growth rate in % | 16.3 | 21.4 | 21.3 | 21.9 | 20.8 | 27.0 | 17 | 12 | 11 |
| Exports of services, BOP, EUR mn ⁴⁾ | 6325 | 7503 | 9000 | 10337 | 1924 | 2401 | 12000 | 13700 | 15300 |
| annual growth rate in % | 37.0 | 18.6 | 19.9 | 14.9 | 5.0 | 24.6 | 16 | 14 | 12 |
| Imports of services, BOP, EUR mn ⁴⁾ | 5329 | 6054 | 7305 | 8369 | 1845 | 2227 | 10000 | 11500 | 12500 |
| annual growth rate in % | 35.5 | 13.6 | 20.7 | 14.6 | 11.8 | 20.7 | 19 | 15 | 9 |
| Average exchange rate UAH/USD | 5.319 | 5.125 | 5.050 | 5.050 | 5.050 | 5.050 | 4.9 | 4.8 | 4.8 |
| Average exchange rate UAH/EUR (ECU) | 6.609 | 6.389 | 6.335 | 6.918 | 6.617 | 7.559 | 8 | 7.4 | 6.7 |
| Purchasing power parity UAH/USD, wiiw ⁵⁾ | 1.392 | 1.680 | 1.869 | 2.215 | . | . | . | . | . |
| Purchasing power parity UAH/EUR, wiiw ⁵⁾ | 1.631 | 1.986 | 2.229 | 2.641 | . | . | . | . | . |

Note: The term 'industry' refers to NACE classification C+D+E.

1) Preliminary. - 2) Excluding small enterprises. - 3) From 2004 including lending minus repayments. - 4) Converted from USD at average official cross exchange rate. - 5) wiiw estimates based on the 2005 International Comparison Project benchmark.

Source: wiiw Database incorporating national statistics; wiiw forecasts.