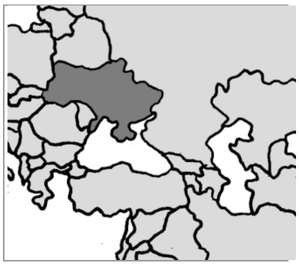

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Ukraine: Advancing state's withdrawal from the economy

The recent developments present a picture of a fairly robust growth accompanied by a further political stabilization. According to preliminary estimates, in 2010 the economy grew by 4.2%, albeit decelerating in the second half of the year due to a relatively poor grain harvest[1] and the domestic demand being increasingly covered by imports. The sources of growth have been shifting too in the course of the year; net exports, as the main growth engine at the beginning of the year, have subsequently been replaced by private consumption and the restocking of inventories. Household demand, which in 2010 soared by 5.8%, was supported by a combination of receding unemployment and an impressive growth in real wages (+7.4%) rather than by consumer credits, which actually declined. Fixed capital formation ceased to be a drag on growth in the second half of 2010, posting a 3.2% increase for the year as a whole. On the supply side, the economic growth was led by industry (+11.2% in gross output terms), particularly its export-oriented branches. Of the latter, machinery did particularly well (+36%), benefiting from the on-going recovery in Russia, with which the relations had improved markedly following the victory of Mr. Yanukovych in presidential elections in February 2010. The performance of sectors oriented towards the domestic market was generally less impressive. The dynamics of agricultural output was marginally negative, while construction posted another decline (by 5.4%), following the double-digit declines in both 2008 and 2009.

Meanwhile, the recent consolidation of political power facilitates the implementation of (partly unpopular) reforms, particularly those in the fiscal area. Some of these reforms result from conditionalities attached to the 2.5-year USD 15.2 billion IMF 'stand-by' package agreed in summer 2010 (of which USD 3.4 billion have already been transferred). However, and more generally, they reflect the 'pro-business' stance of the new authorities in economic policy terms – particularly when compared to the more 'left-leaning' and arguably populist economic policies pursued by the former Prime Minister Tymoshenko. Thus, the 2011 government budget is based on the idea to reduce both government revenues as a share of GDP *and* the fiscal deficit at the same time. On the revenue side,

1 According to official estimates, the grain harvest in 2010 amounted to 39 million tons – 15% lower than the year before.

the budget reflects the newly adopted Tax Code which envisages some fundamental changes in taxation and tax administration. The profit tax rate will be cut as of 1 April 2011 from 25% to 23%, followed by further successive cuts to 16% by 2014. Besides, the new Code provides for a number of tax breaks such as the zero profit tax till 2016 for enterprises with an annual turnover less than UAH 3 million and no VAT rate for some agricultural and wood products. The new Code also stipulates an 'automatic' VAT refund procedure to exporters, which should help solve the long-standing problem of VAT refund arrears. The new Tax Code introduces, as of 2012, a tax on real estate (the rate of which will be set by local authorities) and a 5% tax on interest from household deposits starting from 2015. Meanwhile, the simplified taxation of small businesses has been left intact under the pressure from widespread popular protests. Besides, the overall VAT rate will be cut from 20% to 17% starting from 2014. At the same time, the excise taxes on gasoline and tobacco have been raised, and the 15% flat personal income tax has been replaced by a slightly progressive 15-17% scheme.

Despite only a marginal growth in the planned fiscal revenues (in real terms), the 2011 deficit of the general budget is to be contained at 3.5% of GDP (down from 6% in 2010), which implies an over-proportional reduction in government expenditures. The latter is to be achieved via a broad set of measures. Following the already implemented 50% hike as of 1 August 2010, the household gas tariffs are to be raised by another 30% in the course of this year, which should further reduce budget subsidies to the state-owned energy monopolist Naftohaz. Also, the deficit of the pension fund (also covered from the state budget) is to be reduced *inter alia* by gradually raising the retirement age for women from 55 to (ultimately) 60 years, although the corresponding legislation has not been passed yet. Finally, in the wake of the newly launched public administration reform, the government has been reshuffled and is undergoing a radical downsizing, by some 30% in personnel terms. The key idea behind these IMF-sponsored austerity measures is to bring the country's public debt as a share of GDP on a sustained downward path (below 30%). Ironically however, at least initially, it will almost certainly grow because of the arriving IMF tranches, which are expected to total USD 6.5 billion in 2011. In our view, given the country's reasonably strong balance-of-payments and the manageable fiscal situation, the need for IMF funds is far from obvious in the current circumstances. At the same time, the expected robust economic growth – in tandem with high inflation – would most probably enable at least a stabilization of the public debt to GDP ratio in the coming years at the current level of around 40% (which is not excessively high in any case) even without resorting to socially painful austerity measures, such as the effectively planned pension cuts.

In autumn 2010, capital flows to a number of emerging economies intensified, creating an upward pressure on their currencies. The repercussions on Ukraine, however, proved negligible so far. Quite on the contrary, in the last four months of the previous year, the country's National Bank was mostly *selling* foreign exchange in order to counteract persistent depreciation pressure on the hryvnia. This pressure stemmed partly from the re-emerging current account deficit (after the external sector had been broadly balanced in the first half of 2010), but more importantly, from the large-scale purchases of foreign cash, which totalled USD 6.1 billion between September and December 2010. The latter may be partly explained by the risen inflationary expectations, given the modest summer harvest, and the dynamics of global food prices. In September 2010, the consumer price inflation accelerated sharply, to 2.9% on the monthly basis. Although in subsequent months its pace was suppressed by the imposed export restrictions on grain and the delays in utility tariffs hikes, the inflationary pressures are likely to intensify in the coming months. Therefore, for 2011 as a whole, we expect consumer price inflation to reach around 10% on annual average. This and the currently abundant liquidity in the banking sector may prompt the National Bank to tighten somewhat its monetary policy stance. So far, the tightening of monetary policy has effectively taken place mainly through the sales of foreign exchange rather than via adjustments in the discount rate. However, the most recent developments suggest that this may change soon: in January 2011, the demand for foreign cash subsided, whereas otherwise capital inflows remained strong and the net purchases of foreign exchange by the National Bank turned again positive.

For the coming years, we expect a continuation of the current path of economic growth between 4 and 5% per year, driven largely by the growth in private consumption accompanied by a moderate widening of external deficits. Private consumption will be backed mainly by further improvements in real wages, whereas employment is unlikely to start growing before 2012, given the planned lay-offs in the public sector this year. Fixed investments should also pick up markedly, helped not least by the implemented infrastructure projects ahead of the European Football Championship in 2012. At the same time, the contribution of net exports to growth will be increasingly negative, even under an optimistic assumption that exports and imports grow at the same pace. Also, the ongoing public administration reform should suppress public consumption. The banking sector – which in 2010 recorded losses once again (albeit on a smaller scale than the year before) – is unlikely to become an important force behind the recovery of consumer demand, at least initially. Last year, the volume of consumer loans fell by 13.1% in nominal terms, and the overall credit dynamics was nearly stagnant, although trends in corporate lending have been more encouraging (+8.4%).

Politically, it appears that the country has entered a prolonged period of stability. Virtually all power is concentrated in the hands of Mr. Yanukovych and his Party of Regions, which – following the recent reversal of the constitutional reforms enacted at the onset of the 'orange revolution' – is now also less dependent on support from its initial coalition partners: the Communists and the centrist Lytvyn Block. This political consolidation has been accompanied by a strengthening of authoritarian trends, manifested inter alia in the reported reduction of media freedoms. In turn, the 'orange' opposition, (still) largely centred around Ms. Tymoshenko, remains generally divided and weak, and has increasingly become a target of criminal prosecutions (some of them probably politically motivated). These developments resemble to a certain extent those observed in Russia in the first few years of the past decade, when the persistent infighting and political paralysis throughout most of the 1990s was succeeded by a more authoritarian system, which tamed the oligarchs and ensured a higher degree of stability. Although Ukraine's pronounced cultural and linguistic East-West divide makes a repetition of the 'Russian scenario' more difficult, Mr. Yanukovych's regime could potentially benefit from sustained economic improvements. The deep disappointment of Ukrainian voters with the absence of any real prospects of EU integration has been another important factor behind Mr. Yanukovych's electoral success and may well continue to remain so for some time. The free trade negotiations with the EU are reportedly advancing very slowly, while the goal of a visa-free regime for Ukrainians entering the EU appears even more remote. Still, on 1 February 2011 Ukraine joined the EU Energy Community, which potentially means that it will have to gradually liberalize its gas and electricity sectors and adjust its energy legislation in line with the EU norms.

Table UA

Ukraine: Selected Economic Indicators

	2005	2006	2007	2008	2009	2010 1)	2011	2012	2013
								Forecast	
Population, th pers., average	47105	46788	46509	46258	46053	45871	45750	45600	45500
Gross domestic product, UAH mn, nom.	441452	544153	720731	948056	913345	1085935	1248300	1415600	1590400
annual change in % (real)	2.7	7.3	7.9	2.3	-14.8	4.2	4.5	5	5
GDP/capita (EUR at exchange rate)	1500	1800	2200	2700	1800	2200	.	.	.
GDP/capita (EUR at PPP - wiiw)	4700	5200	5800	6000	5100	5400	.	.	.
Consumption of households, UAH mn, nom.	252624	319383	423174	582482	581733	675023	.	.	.
annual change in % (real)	16.6	15.9	17.2	13.1	-14.9	5.8	5	5.5	6
Gross fixed capital form., UAH mn, nom.	96965	133874	198348	250158	167644	196286	.	.	.
annual change in % (real)	3.9	21.2	23.9	-1.2	-50.5	3.2	12	10	8
Gross industrial production									
annual change in % (real)	3.1	6.2	7.6	-5.2	-21.9	11.2	7	6.5	6
Gross agricultural production									
annual change in % (real)	0.1	2.5	-6.5	17.1	-1.8	-1.0	.	.	.
Construction industry									
annual change in % (real)	-6.6	9.9	15.6	-15.8	-48.2	-5.4	.	.	.
Employed persons - LFS, th, average	20680.0	20730.4	20904.7	20972.3	20191.5	20200	20200	20250	20290
annual change in %	1.9	0.2	0.8	0.3	-3.7	0	0	0.2	0.2
Unemployed persons - LFS, th, average	1600.8	1515.0	1417.6	1425.1	1958.8	1900	.	.	.
Unemployment rate - LFS, in %, average	7.2	6.8	6.4	6.4	8.8	8.6	8.6	8.4	8.2
Reg. unemployment rate, in %, end of period	3.1	2.7	2.3	3.0	1.9	2.0	.	.	.
Average gross monthly wages, UAH 2)	806.2	1041.4	1351.0	1806.0	1906.0	2239.0	.	.	.
annual change in % (real, gross)	20.4	18.4	15.0	6.8	-8.9	7.4	.	.	.
Consumer prices, % p.a.	13.5	9.1	12.8	25.2	15.9	9.4	10	8	7
Producer prices in industry, % p.a. 3)	16.7	9.6	19.5	35.5	6.5	20.9	.	.	.
General governm.budget, nat.def., % GDP									
Revenues	30.4	31.6	30.5	31.4	29.9	29	.	.	.
Expenditures	32.2	32.3	31.6	32.8	34.0	35	.	.	.
Deficit (-) / surplus (+) 4)	-1.8	-0.7	-1.1	-1.5	-4.1	-6	-4	-3	-3
Public debt, nat.def., in % of GDP	17.7	14.8	12.3	20.0	34.8	39.8	43	43	41
Central bank policy rate, % p.a., end of period 5)	9.5	8.5	8.0	12.0	10.3	7.8	.	.	.
Current account, EUR mn 6)	2030	-1289	-3849	-8721	-1242	-1927	-3000	-4000	-5000
Current account in % of GDP	2.9	-1.5	-3.7	-7.1	-1.5	-1.9	-2.5	-2.9	-3.2
Exports of goods, BOP, EUR mn 6)	28093	31048	36383	46274	28958	39268	43200	46700	50400
annual growth rate in %	4.4	10.5	17.2	27.2	-37.4	35.6	10	8	8
Imports of goods, BOP, EUR mn 6)	29004	35188	44100	57270	32046	45594	51100	56200	61800
annual growth rate in %	21.4	21.3	25.3	29.9	-44.0	42.3	12	10	10
Exports of services, BOP, EUR mn 6)	7503	9000	10337	12228	9936	12704	14600	16400	18000
annual growth rate in %	18.6	19.9	14.9	18.3	-18.8	27.9	15	12	10
Imports of services, BOP, EUR mn 6)	6054	7305	8571	11039	8248	9156	10100	11300	12900
annual growth rate in %	13.6	20.7	17.3	28.8	-25.3	11.0	10	12	14
FDI inflow, EUR mn 6)	6263	4467	7220	7457	3453	4500	5000	6000	7000
FDI outflow, EUR mn 6)	221	-106	491	690	116	200	.	.	.
Gross reserves of NB excl. gold, EUR mn	16058	16587	21634	21847	17824	25096	.	.	.
Gross external debt, EUR mn	33504	41391	54421	72109	72062	83000	.	.	.
Gross external debt in % of GDP	45.3	50.6	56.0	82.6	90.3	81	.	.	.
Average exchange rate UAH/EUR	6.389	6.335	6.918	7.708	10.868	10.533	10.5	10	10
Purchasing power parity UAH/EUR, wiiw 7)	1.986	2.227	2.656	3.405	3.909	4.373	.	.	.

1) Preliminary and wiiw estimates. - 2) Excluding small enterprises. - 3) Domestic output prices. - 4) In 2009 budget deficit reached 9.2% of GDP taking into account transfers to Naftohaz and accumulated VAT arrears. - 5) Discount rate of NB. - 6) Converted from USD with the average exchange rate. - 7) wiiw estimates based on the 2005 International Comparison Project benchmark.

Source: wiiw Database incorporating national statistics. Forecasts by wiiw.