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Ukraine: external surpluses are over

Strong consumer demand, vigorous investment activity and solid exports have all contributed to impressive GDP growth of 7.9% in January-May 2007. Over the same period, industrial output expanded by 12.1% and construction by 11.5% (in value-added terms). Real retail trade turnover – a proxy for private consumption – was up by 26.2% in January-April. Similarly to last year, the strong consumer demand was partly backed by a respectable 14% gain in real wages. However, their role behind consumption growth has been generally diminishing, as the government of Prime-Minister Viktor Yanukovych (in office since August 2006) allowed only a modest wage growth in the public sector, and rising consumption is increasingly driven by expanding consumer credit. Between January and May alone, the latter expanded by 28.6% in nominal terms – much faster than credit extended to businesses (+16.2%). The lending boom is not least due to the growing presence of foreign banks which have easy access to external funds: as of 1 May, their share reportedly reached some 29% of Ukraine's banking sector capital.

The strong demand for consumer goods is partly spilling over into imports (in particular those of durables), but is also benefiting consumer-oriented branches of the economy such as retail trade and food-processing. Besides, the rapid expansion of consumer credit appears to have boosted housing construction: the latter was up by 45% in the first quarter of 2007 (year-on-year). Overall, investment in fixed assets over the same period rose by 32.2%, reflecting, among other things, an 80% growth in metallurgy which has been increasingly investing in energy-saving technologies following the 'gas price shock' last year. Finally, the solid growth of goods exports (+24.5% in euro terms in January-April, according to the customs statistics) nearly matched the growth of imports and was due to both high world prices for metals and chemicals and the strong demand for Ukrainian machinery and equipment in the CIS countries. (As a result of the latter, Ukraine's total exports to Russia grew by an astonishing 56%.)

However, the currently observed pace of economic growth will probably not be sustained for the year as a whole. In particular, the high figure of exports in the first quarter is largely due to the low statistical base reflecting the low steel prices at the beginning of 2006 – in sharp contrast to much of the rest of the year. Therefore, we expect export growth in 2007 to slow down to around 10%. At the same time, the growth of imports (+25% in January-April) is likely to largely keep its momentum – the combined effect of the booming imports of investment and consumer goods and the higher prices of imported energy (particularly for natural gas). As a result, net exports will be a higher drag on GDP growth for the year as a whole. Also, following the severe drought in May, grain output is likely to be disappointing (and grain export quotas are once again on the government's agenda). In addition, the rapid growth of investments in the first quarter (and of construction in

particular) may have benefited from the mild winter. All in all, we expect economic growth to reach between 6.5% and 7% this year and to decline only marginally in 2008.

An unpleasant side-effect of the current boom is, however, the widening of the external imbalances. In 2006, Ukraine's current account (-1.5% of GDP) turned out to be in the red for the first time since 1998 for the year as a whole. Given imports growing far ahead of exports, a further current account deterioration seems unavoidable, possibly up to 4% of GDP this year and even higher in 2008. In addition to the negative trade developments, the current account will also be increasingly affected by the interest payments on foreign loans and FDI-related profits. However, this development should not represent a real reason for concern, given the similar patterns observed earlier in the Central European new EU member states: their current account deficits were typically offset by inflows of FDI and resulted largely from large-scale imports of FDI-related investment goods needed for modernization. In 2006, FDI inflows into Ukraine (EUR 4.1 billion) were three times the size of its current account deficit, and they should be sufficient to finance it again this year, in view of the upcoming ambitious privatisation deals (such as of Ukrtelekom and the Odessa Port Plant) and the looming WTO accession. In June 2007, President Yushchenko signed into law the remaining WTO-related bills (such as on food safety, export duties on scrap metal and seeds, VAT on agricultural producers, and intellectual property rights), and the last remaining bilateral deal on market access – with Kyrgyzstan – was reached in May.

Against the background of high capital inflows, the National Bank is having no problems in defending the *de facto* hryvnia peg to the US dollar. On the contrary, its foreign exchange reserves had been persistently on the rise and reached nearly USD 25 billion by the end of May. Also, the UAH and USD interest rates are gradually converging,¹ pointing to the prevailing expectations of (at least) exchange rate stability. Another possible manifestation of growing confidence in the domestic currency is the replacement of hard-currency deposits by hryvnia, which started in May. In fact, the National Bank might let the currency appreciate somewhat in case it decides to adopt inflation targeting – an option currently under discussion. However, it remains to be seen whether inflation targeting as a monetary policy concept would be all that instrumental, given the high degree of the country's economic openness and major risks to price stability emanating primarily from the supply side (such as further energy price hikes). So far this year, domestic energy tariff adjustments have been largely avoided,² resulting in consumer price inflation of a mere 1.9% between January and May. However, producer price inflation accelerated sharply (to

¹ The spread between them stands currently at 2 percentage points for both deposits and credits (in average weighted terms).

² The current gas tariffs charged to households depend on the volumes consumed and start from around USD 62 per thousand cubic metres (th cm) – much below the border price Ukraine has been paying for its gas imports since the start of the year (USD 130 per th cm). However, any domestic price hikes will be almost certainly delayed until after the parliamentary elections on 30 September (see below).

9.8% over the same period) due to the high price dynamics for Ukraine's major export commodities, and will increasingly spill over into consumer prices.

Both financial markets and the country's economy in general have so far been virtually unaffected by a new spiral of political crisis triggered by the dissolution of the Verkhovna Rada (Parliament) by President Yushchenko on 2 April 2007. The move is to be seen as the President's response to the continuous expansion of the ruling parliamentary coalition (controlled by Mr Yushchenko's political rival Mr Yanukovich), which was gradually approaching a two-thirds majority – enough to enact constitutional amendments shifting still further powers from the president to the parliament. Although the president's right to dissolve the Rada under these circumstances was questionable at best (the Constitutional Court has been unable to judge on the issue), the subsequent months have witnessed prolonged negotiations which have resulted in a compromise on early parliamentary elections scheduled for 30 September 2007.

Ironically, the new elections are unlikely to substantially shift the balance of 'orange' and 'anti-orange' forces in the Rada. Nor will they mend the existing political tensions and the country's deep split between the pro-European West and the pro-Russian East. The party of Mr Yanukovich is almost certain to win again and has good chances of forming a new government. The prospect of Mr Yanukovich staying in office may be not a bad piece of news for the business environment and probably partly explains the remarkable resilience of the economy to the political turbulence so far. The only tangible outcome of the early elections could be a somewhat smaller fragmentation of the country's political landscape and further consolidation of influence within the two political poles: by Ms Tymoshenko within the 'orange' camp (at the expense of President Yushchenko) and by Mr Yanukovich within the opposite camp. Both politicians are widely seen as the key contenders in the next presidential elections scheduled for 2009.

Table UA

Ukraine: Selected Economic Indicators

	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007 1st quarter	2007 forecast	2008 forecast
Population, th pers., end of period	48003.5	47622.4	47280.8	46929.5	46646.0	46831.7	46559.6	46300	46000
Gross domestic product, UAH mn, nom.	225810	267344	345113	424741	537667	105423	132252	630000	728000
annual change in % (real)	5.2	9.6	12.1	2.6	7.1	4.1	8.0	6.5	6
GDP/capita (EUR at exchange rate)	931	928	1100	1411	1814	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	4630	5130	5920	6250	6870	.	.	.	.
Gross industrial production									
annual change in % (real)	7.0	15.8	12.5	3.1	6.2	0.6	12.5	8	7
Gross agricultural production									
annual change in % (real)	1.2	-11.0	19.7	-0.1	0.4	4.0	5.0	.	.
Construction output total									
annual change in % (real)	-5.8	26.5	17.2	-6.6	9.8	5.0	16.1	.	.
Consumption of households, UAH mn, nom.	124560	146301	180956	238961	315317	66695	.	.	.
annual change in % (real)	9.5	11.5	13.5	16.6	14.4	20.2	.	.	.
Gross fixed capital form., UAH mn, nom.	43289	55075	77820	93357	129037	21494	.	.	.
annual change in % (real)	3.4	22.5	20.5	-0.3	18.7	19.9	.	20	15
LFS - employed persons, th, avg.	20091.2	20163.3	20295.7	20680.0	20730.4	20432.9	.	.	.
annual change in %	0.6	0.4	0.7	1.9	0.2	.	.	.	.
Reg. employees in industry, th pers., avg. ²⁾	3578.1	3416.0	3408.3	3415.8	3361.9	3378.2	3303.3	.	.
annual change in %	-6.1	-4.5	-0.2	0.2	-1.6	-1.0	-2.2	.	.
LFS - unemployed, th pers., average	2140.7	2008.0	1906.7	1600.8	1515.0	1744.5	.	.	.
LFS - unemployment rate in %, average	9.6	9.1	8.6	7.2	6.8	7.9	.	6.5	6.4
Reg. unemployment rate in %, end of period	3.8	3.6	3.5	3.1	2.5	3.2	2.8	2.4	2.3
Average gross monthly wages, UAH ²⁾	376.4	462.3	589.6	806.2	1041.4	918.3	1161	.	.
annual change in % (real, gross)	20.0	16.7	17.0	20.4	18.4	23.8	14.7	.	.
Consumer prices, % p.a.	0.8	5.2	9.0	13.5	9.1	9.7	10.2	10	9
Producer prices in industry, % p.a.	3.0	7.6	20.5	16.7	9.5	8.4	16.6	15	8
General governm.budget, nat.def., % GDP									
Revenues	27.4	28.2	26.5	31.6	32.1	31.2	33.3	.	.
Expenditures ³⁾	26.7	28.4	29.7	33.4	32.8	30.8	28.5	.	.
Deficit (-) / surplus (+), % GDP	0.7	-0.2	-3.2	-1.8	-0.7	0.4	4.8	-2.6 ⁴⁾	.
Public debt in % of GDP	33.5	29.0	24.7	17.7	15.0	.	.	.	.
Refinancing rate of NB % p.a., end of period	7.0	7.0	9.0	9.5	8.5	9.5	8.5	.	.
Current account, EUR mn ⁵⁾	3360	2559	5560	2030	-1289	-638	-915.8	-4000	-6000
Current account in % of GDP	7.5	5.8	10.6	3.1	-1.5	-3.7	-4.6	-3.8	-4.9
Gross reserves of NB excl. gold, EUR mn ⁶⁾	4088	5348	6977	16058	16587	13921	16813.7	.	.
Gross external debt, EUR mn	12247	19055	22528	33504	41219	33901	.	.	.
Gross external debt in % of GDP	27.3	42.9	43.1	50.4	48.7	.	.	.	.
FDI inflow, EUR mn ⁵⁾	734	1261	1380	6263	4148	877	740	.	.
FDI outflow, EUR mn ⁵⁾	-5	12	3	221	-106	-1	.	.	.
Exports of goods, BOP, EUR mn ⁵⁾	19770	21013	26906	28093	31048	6822	8240	34000	37400
annual growth rate in %	3.6	6.3	28.0	4.4	10.5	5.0	20.8	10	10
Imports of goods, BOP, EUR mn ⁵⁾	19018	20555	23895	29004	35188	7949	9620	42200	47300
annual growth rate in %	0.9	8.1	16.3	21.4	21.3	38.9	21.0	20	12
Exports of services, BOP, EUR mn ⁵⁾	4958	4615	6325	7503	9000	1833	1880	10100	11100
annual growth rate in %	11.2	-6.9	37.0	18.6	19.9	28.3	2.6	12	10
Imports of services, BOP, EUR mn ⁵⁾	3743	3934	5329	6054	7305	1651	1760	8900	10700
annual growth rate in %	-6.3	5.1	35.5	13.6	20.7	28.4	6.6	22	20
Average exchange rate UAH/USD	5.327	5.333	5.319	5.125	5.050	5.050	5.050	5	5
Average exchange rate UAH/EUR (ECU)	5.030	6.024	6.609	6.389	6.335	6.067	6.617	6.5	6.5
Purchasing power parity UAH/USD, wiiw	0.943	0.997	1.117	1.301	1.495	.	.	.	.
Purchasing power parity UAH/EUR, wiiw	1.013	1.091	1.228	1.443	1.672	.	.	.	.

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) Central budget deficit passed by Parliament in December 2006. - 5) Converted from USD. - 6) Useable.

Source: wiiw Database incorporating national statistics; wiiw forecasts.